

OLD SECOND BANCORP INC

Form 10-Q

November 12, 2014

Table of Contents

I

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF
THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2014

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE
SECURITIES EXCHANGE ACT OF 1934

For transition period from to

Commission File Number 0 -10537

OLD SECOND BANCORP, INC.

(Exact name of Registrant as specified in its charter)

Delaware

36-3143493

Edgar Filing: OLD SECOND BANCORP INC - Form 10-Q

(State or other jurisdiction of incorporation or organization) (I.R.S. Employer Identification Number)

37 South River Street, Aurora, Illinois 60507

(Address of principal executive offices) (Zip Code)

(630) 892-0202

(Registrant's telephone number, including area code)

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Act). (check one):

Large accelerated filer Accelerated filer Non-accelerated filer (do not check if a smaller reporting company) Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Exchange Act Rule 12b-2).

Yes No

Indicate the number of shares outstanding of each of the issuer's classes of common stock as of the latest practicable date: As of November 7, 2014, the Registrant had outstanding 29,442,508 shares of common stock, \$1.00 par value per share.



Table of Contents

OLD SECOND BANCORP, INC.

Form 10-Q Quarterly Report

Table of Contents

| | Page Number |
|---|-------------|
| <u>PART I</u> | |
| <u>Item 1.</u> <u>Financial Statements</u> | 3 |
| <u>Item 2.</u> <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 35 |
| <u>Item 3.</u> <u>Quantitative and Qualitative Disclosures about Market Risk</u> | 50 |
| <u>Item 4.</u> <u>Controls and Procedures</u> | 51 |
| <u>PART II</u> | |
| <u>Item 1.</u> <u>Legal Proceedings</u> | 53 |
| <u>Item 1.A.</u> <u>Risk Factors</u> | 53 |
| <u>Item 2.</u> <u>Unregistered Sales of Equity Securities and Use of Proceeds</u> | 53 |
| <u>Item 3.</u> <u>Defaults Upon Senior Securities</u> | 53 |
| <u>Item 4.</u> <u>Mine Safety Disclosure</u> | 53 |
| <u>Item 5.</u> <u>Other Information</u> | 53 |
| <u>Item 6.</u> <u>Exhibits</u> | 53 |
| <u>Signatures</u> | 54 |

Table of Contents

PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

Old Second Bancorp, Inc. and Subsidiaries

Consolidated Balance Sheets

(In thousands, except share data)

| | (Unaudited) September 30, 2014 | December 31, 2013 |
|---|--------------------------------------|----------------------|
| Assets | | |
| Cash and due from banks | \$ 33,260 | \$ 33,210 |
| Interest bearing deposits with financial institutions | 10,797 | 14,450 |
| Cash and cash equivalents | 44,057 | 47,660 |
| Securities available-for-sale, at fair value | 362,243 | 372,191 |
| Securities held-to-maturity, at amortized cost | 263,040 | 256,571 |
| Federal Home Loan Bank and Federal Reserve Bank stock | 9,058 | 10,292 |
| Loans held-for-sale | 3,422 | 3,822 |
| Loans | 1,140,882 | 1,101,256 |
| Less: allowance for loan losses | 23,330 | 27,281 |
| Net loans | 1,117,552 | 1,073,975 |
| Premises and equipment, net | 42,557 | 46,005 |
| Other real estate owned | 40,877 | 41,537 |
| Mortgage servicing rights, net | 5,640 | 5,807 |
| Core deposit, net | - | 1,177 |
| Bank-owned life insurance (BOLI) | 56,438 | 55,410 |
| Deferred tax assets, net | 71,375 | 75,303 |
| Other assets | 16,840 | 14,284 |
| Total assets | \$ 2,033,099 | \$ 2,004,034 |
| Liabilities | | |
| Deposits: | | |
| Noninterest bearing demand | \$ 380,687 | \$ 373,389 |
| Interest bearing: | | |
| Savings, NOW, and money market | 848,372 | 836,300 |
| Time | 427,696 | 472,439 |
| Total deposits | 1,656,755 | 1,682,128 |
| Securities sold under repurchase agreements | 29,438 | 22,560 |
| Other short-term borrowings | 40,000 | 5,000 |
| Junior subordinated debentures | 58,378 | 58,378 |
| Subordinated debt | 45,000 | 45,000 |
| Notes payable and other borrowings | 500 | 500 |

Edgar Filing: OLD SECOND BANCORP INC - Form 10-Q

| | | |
|--|--------------|--------------|
| Other liabilities | 10,337 | 42,776 |
| Total liabilities | 1,840,408 | 1,856,342 |
| Stockholders' Equity | | |
| Preferred stock | 47,331 | 72,942 |
| Common stock | 34,365 | 18,830 |
| Additional paid-in capital | 115,290 | 66,212 |
| Retained earnings | 98,786 | 92,549 |
| Accumulated other comprehensive loss | (7,232) | (7,038) |
| Treasury stock | (95,849) | (95,803) |
| Total stockholders' equity | 192,691 | 147,692 |
| Total liabilities and stockholders' equity | \$ 2,033,099 | \$ 2,004,034 |

| | September 30, 2014 | | December 31, 2013 | |
|--------------------|----------------------------|-------------------------|----------------------------|-------------------------|
| | Preferred Stock \$ 1 | Common Stock \$ 1 | Preferred Stock \$ 1 | Common Stock \$ 1 |
| Par value | \$ 1 | \$ 1 | \$ 1 | \$ 1 |
| Liquidation value | 1,000 | n/a | 1,000 | n/a |
| Shares authorized | 300,000 | 60,000,000 | 300,000 | 60,000,000 |
| Shares issued | 47,331 | 34,364,734 | 73,000 | 18,829,734 |
| Shares outstanding | 47,331 | 29,442,508 | 73,000 | 13,917,108 |
| Treasury shares | - | 4,922,226 | - | 4,912,626 |

See accompanying notes to consolidated financial statements.

Table of Contents

Old Second Bancorp, Inc. and Subsidiaries

Consolidated Statements of Operations

(In thousands, except share data)

| | (unaudited) Three Months Ended September 30, | | (unaudited) Nine Months Ended September 30, | |
|---|--|-----------|---|-----------|
| | 2014 | 2013 | 2014 | 2013 |
| Interest and dividend income | | | | |
| Loans, including fees | \$ 13,362 | \$ 14,327 | \$ 39,346 | \$ 43,153 |
| Loans held-for-sale | 38 | 38 | 92 | 124 |
| Securities: | | | | |
| Taxable | 3,586 | 3,113 | 10,440 | 8,109 |
| Tax exempt | 110 | 148 | 376 | 441 |
| Dividends from Federal Reserve Bank and Federal Home Loan Bank stock | 78 | 76 | 232 | 228 |
| Interest bearing deposits with financial institutions | 25 | 22 | 60 | 91 |
| Total interest and dividend income | 17,199 | 17,724 | 50,546 | 52,146 |
| Interest expense | | | | |
| Savings, NOW, and money market deposits | 175 | 206 | 562 | 655 |
| Time deposits | 1,073 | 1,674 | 3,604 | 5,327 |
| Other short-term borrowings | 5 | 6 | 10 | 26 |
| Junior subordinated debentures | 1,072 | 1,336 | 3,847 | 3,937 |
| Subordinated debt | 199 | 209 | 593 | 610 |
| Notes payable and other borrowings | 4 | 4 | 12 | 12 |
| Total interest expense | 2,528 | 3,435 | 8,628 | 10,567 |
| Net interest and dividend income | 14,671 | 14,289 | 41,918 | 41,579 |
| Loan loss reserve release | - | (1,750) | (2,000) | (6,050) |
| Net interest and dividend income after provision for loan losses | 14,671 | 16,039 | 43,918 | 47,629 |
| Noninterest income | | | | |
| Trust income | 1,483 | 1,494 | 4,619 | 4,666 |
| Service charges on deposits | 1,838 | 1,904 | 5,354 | 5,379 |
| Secondary mortgage fees | 174 | 183 | 441 | 680 |
| Mortgage servicing gain, net of changes in fair value | 252 | 235 | 269 | 1,222 |
| Net gain on sales of mortgage loans | 914 | 814 | 2,614 | 4,601 |
| Securities gains (loss), net | 1,231 | (7) | 1,457 | 2,191 |
| Increase in cash surrender value of bank-owned life insurance | 304 | 419 | 1,028 | 1,198 |
| Death benefit realized on bank-owned life insurance | - | 6 | - | 381 |
| Debit card interchange income | 1,011 | 873 | 2,771 | 2,565 |
| Other income | 1,116 | 1,549 | 3,572 | 4,434 |
| Total noninterest income | 8,323 | 7,470 | 22,125 | 27,317 |
| Noninterest expense | | | | |

Edgar Filing: OLD SECOND BANCORP INC - Form 10-Q

| | | | | |
|---|----------|-----------|----------|-----------|
| Salaries and employee benefits | 8,856 | 9,299 | 27,140 | 27,508 |
| Occupancy expense, net | 1,143 | 1,266 | 3,809 | 3,787 |
| Furniture and equipment expense | 989 | 1,026 | 2,956 | 3,274 |
| FDIC insurance | 649 | 987 | 1,555 | 3,046 |
| General bank insurance | 371 | 489 | 1,203 | 1,829 |
| Amortization of core deposit | 154 | 524 | 1,177 | 1,574 |
| Advertising expense | 291 | 347 | 1,053 | 841 |
| Debit card interchange expense | 418 | 366 | 1,208 | 1,072 |
| Legal fees | 332 | 615 | 998 | 1,424 |
| Other real estate expense, net | 2,007 | 2,544 | 4,665 | 8,943 |
| Other expense | 3,134 | 3,119 | 9,148 | 9,773 |
| Total noninterest expense | 18,344 | 20,582 | 54,912 | 63,071 |
| Income before income taxes | 4,650 | 2,927 | 11,131 | 11,875 |
| Provision (benefit) for income taxes | 1,726 | (69,997) | 3,984 | (69,997) |
| Net income | \$ 2,924 | \$ 72,924 | \$ 7,147 | \$ 81,872 |
| Preferred stock dividends and accretion of discount | 1,065 | 1,323 | 3,985 | 3,917 |
| Dividends waived upon preferred stock redemption | - | - | (5,433) | - |
| Gain on preferred stock redemption | - | - | (1,348) | - |
| Net income available to common stockholders | \$ 1,859 | \$ 71,601 | \$ 9,943 | \$ 77,955 |
| Basic earnings per share | \$ 0.06 | \$ 5.08 | \$ 0.41 | \$ 5.52 |
| Diluted earnings per share | 0.06 | 5.08 | 0.41 | 5.52 |

See accompanying notes to consolidated financial statements.

Table of Contents

Old Second Bancorp, Inc. and Subsidiaries

Consolidated Statements of Comprehensive Income (Loss)

(In thousands)

| | (Unaudited) Three Months Ended September 30, | | (Unaudited) Nine Months Ended September 30, | |
|---|--|-----------|---|-----------|
| | 2014 | 2013 | 2014 | 2013 |
| Net Income | \$ 2,924 | \$ 72,924 | \$ 7,147 | \$ 81,872 |
| Unrealized holding (losses) gains on available-for-sale securities arising during the period | (2,224) | (3,411) | 397 | (16,780) |
| Related tax benefit (expense) | 918 | 1,405 | (161) | 6,913 |
| Holding (losses) gains after tax on available-for-sale securities | (1,306) | (2,006) | 236 | (9,867) |
| Less: Reclassification adjustment for the net gains realized during the period | | | | |
| Net realized gains (losses) | 1,231 | (7) | 1,457 | 2,191 |
| Income tax (expense) benefit on net realized gains (losses) | (504) | 3 | (597) | (899) |
| Net realized gains (losses) after tax | 727 | (4) | 860 | 1,292 |
| Other comprehensive loss on available-for-sale securities | (2,033) | (2,002) | (624) | (11,159) |
| Accretion of net unrealized holding losses on held-to-maturity transferred from available-for-sale securities | 237 | 87 | 731 | 87 |
| Related tax expense | (97) | (36) | (301) | (36) |
| Other comprehensive income on held-to-maturity securities | 140 | 51 | 430 | 51 |
| Total other comprehensive loss | (1,893) | (1,951) | (194) | (11,108) |
| Total comprehensive income | \$ 1,031 | \$ 70,973 | \$ 6,953 | \$ 70,764 |

See accompanying notes to consolidated financial statements.

Table of Contents

Old Second Bancorp, Inc. and Subsidiaries

Consolidated Statements of Cash Flows

(In thousands)

| | (Unaudited) | |
|---|-------------------|-----------|
| | Nine Months Ended | |
| | September 30, | |
| | 2014 | 2013 |
| Cash flows from operating activities | | |
| Net income | \$ 7,147 | \$ 81,872 |
| Adjustments to reconcile net income to net cash (used in) provided by operating activities: | | |
| Depreciation and amortization of leasehold improvement | 1,887 | 2,147 |
| Change in fair value of mortgage servicing rights | 761 | (81) |
| Loan loss reserve release | (2,000) | (6,050) |
| Gain on recapture of restricted stock | - | (612) |
| Provision for deferred tax expense (benefit) | 4,063 | (70,161) |
| Originations of loans held-for-sale | (85,172) | (151,601) |
| Proceeds from sales of loans held-for-sale | 87,569 | 160,966 |
| Net gain on sales of mortgage loans | (2,614) | (4,601) |
| Change in current income taxes payable | (79) | (101) |
| Increase in cash surrender value of bank-owned life insurance | (1,028) | (1,198) |
| Death claim on bank-owned life insurance | - | 396 |
| Change in accrued interest receivable and other assets | (3,633) | (334) |
| Change in accrued interest payable and other liabilities | (22,108) | 4,341 |
| Net discount accretion on securities | (1,408) | (131) |
| Securities gains, net | (1,457) | (2,191) |
| Amortization of core deposit | 1,177 | 1,574 |
| Stock based compensation | 189 | 123 |
| Net gain on sale of other real estate owned | (610) | (1,175) |
| Provision for other real estate owned losses | 2,781 | 6,537 |
| Net gain on disposal of fixed assets | - | (5) |
| Loss on transfer of premises to other real estate owned | 121 | - |
| Net cash (used in) provided by operating activities | (14,414) | 19,715 |
| Cash flows from investing activities | | |
| Proceeds from maturities and calls including pay down of securities available-for-sale | 15,430 | 38,175 |
| Proceeds from sales of securities available-for-sale | 264,502 | 484,112 |
| Purchases of securities available-for-sale | (268,639) | (564,372) |
| Proceeds from maturities and calls including pay down of securities held-to-maturity | 5,934 | 541 |
| Purchases of securities held-to-maturity | (11,212) | (21,382) |
| Proceeds from sales of Federal Home Loan Bank stock | 1,234 | 910 |
| Net change in loans | (53,037) | 49,885 |
| Improvements in other real estate owned | (637) | (60) |

Edgar Filing: OLD SECOND BANCORP INC - Form 10-Q

| | | |
|---|-----------|-----------|
| Proceeds from sales of other real estate owned | 12,746 | 32,103 |
| Proceeds from disposition of fixed assets | 1 | 6 |
| Net purchases of premises and equipment | (721) | (1,538) |
| Net cash (used in) provided by investing activities | (34,399) | 18,380 |
| Cash flows from financing activities | | |
| Net change in deposits | (25,373) | (44,096) |
| Net change in securities sold under repurchase agreements | 6,878 | 2,844 |
| Net change in other short-term borrowings | 35,000 | (45,000) |
| Redemption of preferred stock | (24,321) | - |
| Proceeds from issuance of common stock | 64,395 | - |
| Dividends paid | (11,323) | - |
| Purchase of treasury stock | (46) | (278) |
| Net cash provided by (used in) financing activities | 45,210 | (86,530) |
| Net change in cash and cash equivalents | (3,603) | (48,435) |
| Cash and cash equivalents at beginning of period | 47,660 | 128,507 |
| Cash and cash equivalents at end of period | \$ 44,057 | \$ 80,072 |

Table of Contents

Old Second Bancorp, Inc. and Subsidiaries

Consolidated Statements of Cash Flows - Continued

(In thousands)

| | (Unaudited) | |
|---|-------------------|---------|
| | Nine Months Ended | |
| | September 30, | |
| Supplemental cash flow information | 2014 | 2013 |
| Income taxes paid | \$ - | \$ 266 |
| Interest paid for deposits | 4,412 | 6,144 |
| Interest paid for borrowings | 21,425 | 656 |
| Non-cash transfer of loans to other real estate owned | 11,460 | 14,196 |
| Non-cash transfer of premises to other real estate owned | 2,160 | - |
| Non-cash transfer of loans to securities available-for-sale | - | 5,329 |
| Non-cash transfer of securities available-for-sale to securities held-to-maturity | - | 237,154 |
| Change in dividends accrued and declared but not paid | (9,123) | 510 |
| Accretion on preferred stock discount | 58 | 798 |
| Fair value difference on recapture of restricted stock | - | 43 |

See accompanying notes to consolidated financial statements.

Table of Contents

Old Second Bancorp, Inc. and Subsidiaries

Consolidated Statements of Changes in

Stockholders' Equity

(In thousands)

| | Common Stock | Preferred Stock | Additional Paid-In Capital | Retained Earnings | Accumulated Other Comprehensive Income (Loss) | Treasury Stock | Total Stockholders' Equity |
|--|-----------------|--------------------|----------------------------------|----------------------|---|-------------------|----------------------------------|
| Balance, December 31, 2012 | \$ 18,729 | \$ 71,869 | \$ 66,189 | \$ 12,048 | \$ (1,327) | \$ (94,956) | \$ 72,552 |
| Net income | | | | 81,872 | | | 81,872 |
| Other comprehensive loss, net of tax | | | | | (11,108) | | (11,108) |
| Change in restricted stock | 101 | | (101) | | | | - |
| Recapture of restricted stock | | | (43) | | | (569) | (612) |
| Stock based compensation | | | 123 | | | | 123 |
| Purchase of treasury stock | | | | | | (278) | (278) |
| Preferred stock accretion and declared dividends | | 798 | | (1,308) | | | (510) |
| Balance, September 30, 2013 | \$ 18,830 | \$ 72,667 | \$ 66,168 | \$ 92,612 | \$ (12,435) | \$ (95,803) | \$ 142,039 |
| Balance, December 31, 2013 | \$ 18,830 | \$ 72,942 | \$ 66,212 | \$ 92,549 | \$ (7,038) | \$ (95,803) | \$ 147,692 |
| Net income | | | | 7,147 | | | 7,147 |
| Other comprehensive loss, net of tax | | | | | (194) | | (194) |
| Change in restricted stock | 10 | | (10) | | | | - |
| Tax effect from vesting of restricted stock | | | 29 | | | | 29 |

Edgar Filing: OLD SECOND BANCORP INC - Form 10-Q

| | | | | | | | |
|--|-----------|-----------|------------|-----------|------------|-------------|------------|
| Stock based compensation | | | 189 | | | | 189 |
| Purchase of treasury stock | | | | | (46) | | (46) |
| Redemption of preferred stock | | (25,669) | | 1,348 | | | (24,321) |
| Common stock offering | 15,525 | | 48,870 | | | | 64,395 |
| Preferred stock accretion and declared dividends | | 58 | | (2,258) | | | (2,200) |
| Balance, September 30, 2014 | \$ 34,365 | \$ 47,331 | \$ 115,290 | \$ 98,786 | \$ (7,232) | \$ (95,849) | \$ 192,691 |

See accompanying notes to consolidated financial statements.

Table of Contents

Old Second Bancorp, Inc. and Subsidiaries

Notes to Consolidated Financial Statements

(Table amounts in thousands, except per share data, unaudited)

Note 1 – Summary of Significant Accounting Policies

The accounting policies followed in the preparation of the interim consolidated financial statements are consistent with those used in the preparation of the annual financial information. The interim consolidated financial statements reflect all normal and recurring adjustments, which are necessary, in the opinion of management, for a fair statement of results for the interim period presented. Results for the period ended September 30, 2014, are not necessarily indicative of the results that may be expected for the year ending December 31, 2014. These interim consolidated financial statements are unaudited and should be read in conjunction with the audited financial statements and notes included in Old Second Bancorp, Inc.'s (the "Company") annual report on Form 10-K for the year ended December 31, 2013. Unless otherwise indicated, amounts in the tables contained in the notes to the consolidated financial statements are in thousands. Certain items in prior periods have been reclassified to conform to the current presentation.

The Company's consolidated financial statements are prepared in accordance with United States generally accepted accounting principles ("GAAP") and follow general practices within the banking industry. Application of these principles requires management to make estimates, assumptions, and judgments that affect the amounts reported in the consolidated financial statements and accompanying notes. These estimates, assumptions, and judgments are based on information available as of the date of the consolidated financial statements. Future changes in information may affect these estimates, assumptions, and judgments, which, in turn, may affect amounts reported in the consolidated financial statements.

All significant accounting policies are presented in Note 1 to the consolidated financial statements included in the Company's annual report on Form 10-K for the year ended December 31, 2013. These policies, along with the disclosures presented in the other financial statement notes and in this discussion, provide information on how significant assets and liabilities are valued in the consolidated financial statements and how those values are determined.

Recent Accounting Pronouncements

In July 2013, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2013-11 “Income Taxes (Topic 740) — Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists.” ASU 2013-11 amended existing guidance related to the presentation of an unrecognized tax benefit when a net operating loss carryforward, a similar tax loss or a tax credit carryforward exists. These amendments provide that an unrecognized tax benefit, or a portion thereof, be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward, except to the extent that a net operating loss carryforward, a similar tax loss, or a tax credit carryforward is not available at the reporting date to settle any additional income taxes that would result from disallowance of a tax position, or the tax law does not require the entity to use, and the entity does not intend to use, the deferred tax asset for such purpose, then the unrecognized tax benefit should be presented as a liability. These amendments are effective for interim and annual reporting periods beginning after December 15, 2013, and are incorporated in the financial statements contained in this report. The effect of adopting this standard does not have a material effect on the Company’s operating results or financial condition.

In January 2014, the FASB issued ASU No. 2014-04 Receivables — Troubled Debt Restructurings by Creditors (Subtopic 310-40) — “Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure.” ASU 2014-04 is intended to reduce diversity in practice by clarifying when an in substance repossession or foreclosure occurs, that is, when a creditor should be considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan such that the loan should be derecognized and the real estate property recognized. ASU 2014-04 requires a creditor to reclassify a collateralized consumer mortgage loan to real estate property upon obtaining legal title to the real estate collateral, or the borrower voluntarily conveying all interest in the real estate property to the lender to satisfy the loan through a deed in lieu of foreclosure or similar legal agreement. ASU 2014-04 is effective for public business entities for annual periods, and interim periods within those annual periods, beginning after December 15, 2014. For entities other than public business entities, the amendments in the ASU are effective for annual periods beginning after December 15, 2014, and interim periods within annual periods beginning after December 15, 2015. The adoption of this standard is not expected to have a material effect to the Company’s operating results or financial condition.

In May 2014, the FASB issued ASU No. 2014-09 "Revenue from Contracts with Customers (Topic 606)." The core principle of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods and services. ASU 2014-09 is effective for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period. The amendments can be applied retrospectively to each prior reporting period or retrospectively with the cumulative effect of initially applying this update recognized at the date of initial application. Early application is not permitted. The Company is assessing the impact of ASU 2014-09 on its accounting and disclosures.

Table of Contents

In June 2014, FASB issued Accounting Standards Update (ASU) No. 2014-12 "Compensation - Stock Compensation (Topic 718) - Accounting for Share Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period." ASU 2014-12 requires that a performance target that affects vesting and that could be achieved after the requisite service period be treated as a performance condition. ASU 2014-12 is effective for interim and annual periods beginning after December 15, 2015. The amendments can be applied prospectively to all awards granted or modified after the effective date or retrospectively to all awards with performance targets that are outstanding as of the beginning of the earliest annual period presented and to all new or modified awards thereafter. Early adoption is permitted. The adoption of this standard is not expected to have a material effect to the Company's operating results or financial condition.

In August 2014, FASB issued ASU No. 2014-15 "Presentation of Financial Statements—Going Concern (Subtopic 205-40) Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern." ASU 2014-15 provide guidance in GAAP about management's responsibility to evaluate whether there is substantial doubt about an entity's ability to continue as a going concern and to provide related footnote disclosures. ASU 2014-15 is effective for interim and annual periods beginning after December 15, 2016. The amendments in this Update are effective for the annual period ending after December 15, 2016, and for annual periods and interim periods thereafter. Early application is permitted. The adoption of this standard is not expected to have a material effect to the Company's operating results or financial condition.

Note 2 – Securities

Investment Portfolio Management

Our investment portfolio serves the liquidity and income needs of the Company. While the portfolio serves as an important component of the overall liquidity management at the Bank, portions of the portfolio will also serve as income producing assets. The size and composition of the portfolio reflects liquidity needs, loan demand and interest income objectives.

Portfolio size and composition will be adjusted from time to time. While a significant portion of the portfolio consists of readily marketable securities to address liquidity, other parts of the portfolio may reflect funds invested pending future loan demand or to maximize interest income without undue interest rate risk.

Investments are comprised of debt securities and non-marketable equity investments. Securities available-for-sale are carried at fair value. Unrealized gains and losses, net of tax, on securities available-for-sale are reported as a separate component of equity. This balance sheet component changes as interest rates and market conditions

change. Unrealized gains and losses are not included in the calculation of regulatory capital.

Securities held-to-maturity are carried at amortized cost and the discount or premium created in the 2013 transfer from available-for-sale securities or at the time of purchase thereafter is accreted or amortized to the maturity or expected payoff date but not an earlier call. In accordance with GAAP, the Company has the positive intent and ability to hold the securities to maturity.

Nonmarketable equity investments include Federal Home Loan Bank of Chicago (“FHLBC”) stock and Federal Reserve Bank of Chicago (“Reserve Bank”) stock. FHLBC stock was recorded at \$4.3 million and \$5.5 million at September 30, 2014, and December 31, 2013, respectively. Reserve Bank stock was recorded at \$4.8 million at September 30, 2014, and December 31, 2013. Our FHLBC stock is necessary to maintain access to FHLBC advances.

Table of Contents

The following table summarizes the amortized cost and fair value of the securities portfolio at September 30, 2014 and December 31, 2013 and the corresponding amounts of gross unrealized gains and losses (in thousands):

| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|--|-------------------|------------------------------|-------------------------------|---------------|
| September 30, 2014: | | | | |
| Securities Available-for-Sale | | | | |
| U.S. Treasury | \$ 1,533 | \$ - | \$ (1) | \$ 1,532 |
| U.S. government agencies | 1,718 | - | (80) | 1,638 |
| States and political subdivisions | 13,794 | 313 | (228) | 13,879 |
| Corporate bonds | 31,272 | 65 | (556) | 30,781 |
| Collateralized mortgage obligations | 29,951 | 41 | (1,575) | 28,417 |
| Asset-backed securities | 194,927 | 98 | (2,227) | 192,798 |
| Collateralized loan obligations | 94,202 | - | (1,004) | 93,198 |
| Total Securities Available-for-Sale | \$ 367,397 | \$ 517 | \$ (5,671) | \$ 362,243 |
| Securities Held-to-Maturity | | | | |
| U.S. government agency mortgage-backed | \$ 37,321 | \$ 1,346 | \$ (11) | \$ 38,656 |
| Collateralized mortgage obligations | 225,719 | 2,017 | (2,049) | 225,687 |
| Total Securities Held-to-Maturity | \$ 263,040 | \$ 3,363 | \$ (2,060) | \$ 264,343 |
| | | | | |
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| December 31, 2013: | | | | |
| Securities Available-for-Sale | | | | |
| U.S. Treasury | \$ 1,549 | \$ - | \$ (5) | \$ 1,544 |
| U.S. government agencies | 1,738 | - | (66) | 1,672 |
| States and political subdivisions | 16,382 | 629 | (217) | 16,794 |
| Corporate bonds | 15,733 | 17 | (648) | 15,102 |
| Collateralized mortgage obligations | 66,766 | 256 | (3,146) | 63,876 |
| Asset-backed securities | 274,118 | 2,168 | (3,083) | 273,203 |
| Total Securities Available-for-Sale | \$ 376,286 | \$ 3,070 | \$ (7,165) | \$ 372,191 |
| Securities Held-to-Maturity | | | | |
| U.S. government agency mortgage-backed | \$ 35,268 | \$ 45 | \$ (73) | \$ 35,240 |
| Collateralized mortgage obligations | 221,303 | 643 | (2,858) | 219,088 |
| Total Securities Held-to-Maturity | \$ 256,571 | \$ 688 | \$ (2,931) | \$ 254,328 |

The fair value, amortized cost and weighted average yield of debt securities at September 30, 2014, by contractual maturity, were as follows in the table below. Securities not due at a single maturity date are shown separately.

| | Amortized | Weighted | Fair |
|---|------------|----------|------------|
| | Cost | Average | Value |
| | | Yield | |
| Securities Available-for-Sale | | | |
| Due in one year or less | \$ 410 | 4.50% | \$ 421 |
| Due after one year through five years | 5,811 | 2.87% | 5,992 |
| Due after five years through ten years | 36,724 | 2.44% | 36,218 |
| Due after ten years | 5,372 | 3.31% | 5,199 |
| | 48,317 | 2.61% | 47,830 |
| Collateralized mortgage obligations | 29,951 | 2.46% | 28,417 |
| Asset-back securities | 194,927 | 2.10% | 192,798 |
| Collateralized loan obligations | 94,202 | 2.78% | 93,198 |
| | \$ 367,397 | 2.37% | \$ 362,243 |
| Securities Held-to-Maturity | | | |
| Mortgage-backed and collateralized mortgage obligations | \$ 263,040 | 3.05% | \$ 264,343 |

Edgar Filing: OLD SECOND BANCORP INC - Form 10-Q

Table of Contents

Securities with unrealized losses at September 30, 2014, and December 31, 2013, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, were as follows (in thousands except for number of securities):

| September 30, 2014 | Less than 12 months in an unrealized loss position | | | Greater than 12 months in an unrealized loss position | | | Total Number of | Unrealized | Fair |
|--------------------|---|------------|------------|--|------------|-----------|--------------------|------------|------------|
| | Number of | Unrealized | Fair | Number of | Unrealized | Fair | | | |
| Securities | | | | | | | | | |
| Available-for-Sale | Securities | Losses | Value | Securities | Losses | Value | Securities | Losses | Value |
| Treasury | 1 | \$ 1 | \$ 1,532 | - | \$ - | \$ - | 1 | \$ 1 | \$ 1,532 |
| Government | | | | | | | | | |
| Res | - | - | - | 1 | 80 | 1,638 | 1 | 80 | 1,638 |
| and political | | | | | | | | | |
| visions | 3 | 215 | 4,450 | 2 | 13 | 1,862 | 5 | 228 | 6,312 |
| Rate bonds | 5 | 463 | 20,581 | 2 | 93 | 2,411 | 7 | 556 | 22,992 |
| Realized | | | | | | | | | |
| Age | | | | | | | | | |
| tions | 1 | 18 | 4,739 | 3 | 1,557 | 21,704 | 4 | 1,575 | 26,443 |
| backed | | | | | | | | | |
| ies | 10 | 1,231 | 117,440 | 3 | 996 | 44,042 | 13 | 2,227 | 161,482 |
| Realized loan | | | | | | | | | |
| tions | 13 | 1,004 | 93,198 | - | - | - | 13 | 1,004 | 93,198 |
| | 33 | \$ 2,932 | \$ 241,940 | 11 | \$ 2,739 | \$ 71,657 | 44 | \$ 5,671 | \$ 313,695 |
| Securities | | | | | | | | | |
| o-Maturity | | | | | | | | | |
| overnment | | | | | | | | | |
| / | | | | | | | | | |
| Age-backed | 1 | \$ 11 | \$ 1,972 | - | \$ - | \$ - | 1 | \$ 11 | \$ 1,972 |
| Realized | | | | | | | | | |
| Age | | | | | | | | | |
| tions | 13 | 1,164 | 83,545 | 2 | 885 | 37,828 | 15 | 2,049 | 121,373 |
| | 14 | \$ 1,175 | \$ 85,517 | 2 | \$ 885 | \$ 37,828 | 16 | \$ 2,060 | \$ 121,373 |

| December 31, 2013 | Less than 12 months in an unrealized loss position | | | Greater than 12 months in an unrealized loss position | | | Total Number of | Unrealized | Fair |
|--------------------|---|------------|----------|--|------------|-------|--------------------|------------|----------|
| | Number of | Unrealized | Fair | Number of | Unrealized | Fair | | | |
| Securities | | | | | | | | | |
| Available-for-Sale | Securities | Losses | Value | Securities | Losses | Value | Securities | Losses | Value |
| Treasury | 1 | \$ 5 | \$ 1,544 | - | \$ - | \$ - | 1 | \$ 5 | \$ 1,544 |
| | - | - | - | 1 | 66 | 1,672 | 1 | 66 | 1,672 |

Edgar Filing: OLD SECOND BANCORP INC - Form 10-Q

| | | | | | | | | | |
|-------------------------|----|----------|------------|---|--------|-----------|----|----------|------------|
| government securities | | | | | | | | | |
| and political divisions | 6 | 217 | 4,625 | - | - | - | 6 | 217 | 4,625 |
| corporate bonds | 4 | 429 | 10,493 | 2 | 219 | 2,796 | 6 | 648 | 13,289 |
| securitized | | | | | | | | | |
| mortgage participations | 5 | 3,146 | 54,021 | - | - | - | 5 | 3,146 | 54,021 |
| asset-backed securities | 11 | 2,836 | 99,466 | 2 | 247 | 6,368 | 13 | 3,083 | 105,834 |
| | 27 | \$ 6,633 | \$ 170,149 | 5 | \$ 532 | \$ 10,836 | 32 | \$ 7,165 | \$ 180,665 |
| securities | | | | | | | | | |
| short-to-Maturity | | | | | | | | | |
| government securities | | | | | | | | | |
| asset-backed | 6 | \$ 73 | \$ 19,134 | - | \$ - | \$ - | 6 | \$ 73 | \$ 19,134 |
| securitized | | | | | | | | | |
| mortgage participations | 19 | 2,858 | 156,632 | - | - | - | 19 | 2,858 | 156,632 |
| | 25 | \$ 2,931 | \$ 175,766 | - | \$ - | \$ - | 25 | \$ 2,931 | \$ 175,766 |

Recognition of other-than-temporary impairment was not necessary in the nine months ended September 30, 2014, or the year ended December 31, 2013. The changes in fair value related primarily to interest rate fluctuations. Our review of other-than-temporary impairment confirmed no credit quality deterioration.

Note 3 – Loans

Major classifications of loans were as follows:

| | September 30, 2014 | December 31, 2013 |
|-----------------------------|--------------------|-------------------|
| Commercial | \$ 106,592 | \$ 94,736 |
| Real estate - commercial | 600,649 | 560,233 |
| Real estate - construction | 41,936 | 29,351 |
| Real estate - residential | 365,602 | 390,201 |
| Consumer | 3,142 | 2,760 |
| Overdraft | 1,198 | 628 |
| Lease financing receivables | 8,398 | 10,069 |
| Other | 12,757 | 12,793 |
| | 1,140,274 | 1,100,771 |
| Net deferred loan fees | 608 | 485 |
| | \$ 1,140,882 | \$ 1,101,256 |

It is the policy of the Company to review each prospective credit in order to determine if an adequate level of security or collateral was obtained prior to making a loan. The type of collateral, when required, will vary from liquid assets to real estate. The Company's access to collateral, in the event of borrower default, is assured through adherence to lending laws, the Company's lending standards and credit monitoring procedures. The Bank generally makes loans solely within its market area. There are no significant concentrations of loans where the customers' ability to honor loan terms is dependent upon a single economic sector although the real estate related categories listed above represent 88.4% and 89.0% of the portfolio at September 30, 2014, and December 31, 2013, respectively.

Table of Contents

Aged analysis of past due loans by class of loans were as follows:

| September 30, 2014 | 90 Days or Greater Past | | | | Current | Nonaccrual | Total Loans | Recorded Investment 90 days or Greater Past Due and Accruing |
|---------------------------------------|----------------------------|------------------------|-------|-------------------|--------------|------------|--------------|---|
| | 30-59 Days Past | 60-89 Days Past Due | Due | Total Past Due | | | | |
| Commercial | \$ 99 | \$ - | \$ - | \$ 99 | \$ 113,246 | \$ 1,645 | \$ 114,990 | \$ - |
| Real estate - commercial | | | | | | | | |
| Owner occupied general purpose | 32 | - | - | 32 | 132,123 | 5,973 | 138,128 | - |
| Owner occupied special purpose | - | - | - | - | 166,561 | 3,802 | 170,363 | - |
| Non-owner occupied general purpose | - | - | - | - | 150,073 | 6,421 | 156,494 | - |
| Non-owner occupied special purpose | - | - | - | - | 84,410 | 1,472 | 85,882 | - |
| Retail properties | - | - | - | - | 34,692 | - | 34,692 | - |
| Farm | - | - | - | - | 15,090 | - | 15,090 | - |
| Real estate - construction | | | | | | | | |
| Homebuilder | - | - | - | - | 3,232 | - | 3,232 | - |
| Land | - | - | - | - | 1,684 | 209 | 1,893 | - |
| Commercial speculative | - | - | - | - | 15,859 | - | 15,859 | - |
| All other | - | - | - | - | 20,367 | 585 | 20,952 | - |
| Real estate - residential | | | | | | | | |
| Investor | 173 | 722 | - | 895 | 127,490 | 1,901 | 130,286 | - |
| Owner occupied | 96 | 230 | - | 326 | 109,990 | 7,204 | 117,520 | - |
| Revolving and junior liens | 105 | 78 | 44 | 227 | 115,273 | 2,296 | 117,796 | 44 |
| Consumer | 6 | - | - | 6 | 3,136 | - | 3,142 | - |
| All other | - | - | - | - | 14,563 | - | 14,563 | - |
| | \$ 511 | \$ 1,030 | \$ 44 | \$ 1,585 | \$ 1,107,789 | \$ 31,508 | \$ 1,140,882 | \$ 44 |

Edgar Filing: OLD SECOND BANCORP INC - Form 10-Q

| December 31, 2013 | 90 Days or Greater Past | | | | Current | Nonaccrual | Total Loans | Recorded Investment 90 days or Greater Past Due and Accruing |
|--|----------------------------|------------------------|-------|-------------------|--------------|------------|--------------|---|
| | 30-59 Days Past | 60-89 Days Past Due | Due | Total Past Due | | | | |
| Commercial | \$ - | \$ - | \$ - | \$ - | \$ 104,778 | \$ 27 | \$ 104,805 | \$ - |
| Real estate - commercial | | | | | | | | |
| Owner occupied general purpose | 290 | 526 | - | 816 | 117,938 | 3,180 | 121,934 | - |
| Owner occupied special purpose | 511 | - | - | 511 | 164,277 | 7,671 | 172,459 | - |
| Non-owner occupied general purpose | 218 | - | - | 218 | 132,331 | 5,708 | 138,257 | - |
| Non-owner occupied special purpose | - | - | - | - | 73,325 | 661 | 73,986 | - |
| Retail properties | - | - | - | - | 34,034 | 3,144 | 37,178 | - |
| Farm | - | - | - | - | 16,419 | - | 16,419 | - |
| Real estate - construction | | | | | | | | |
| Homebuilder | - | - | - | - | 3,515 | 168 | 3,683 | - |
| Land | - | - | - | - | 4,436 | 209 | 4,645 | - |
| Commercial speculative | - | - | - | - | 11,235 | 1,913 | 13,148 | - |
| All other | 32 | - | - | 32 | 7,404 | 439 | 7,875 | - |
| Real estate - residential | | | | | | | | |
| Investor | 581 | 171 | - | 752 | 140,926 | 6,615 | 148,293 | - |
| Owner occupied | 4,414 | 308 | 87 | 4,809 | 106,184 | 5,967 | 116,960 | 87 |
| Revolving and junior liens | 650 | 76 | - | 726 | 121,013 | 3,209 | 124,948 | - |
| Consumer | 5 | - | - | 5 | 2,755 | - | 2,760 | - |
| All other1 | - | - | - | - | 13,906 | - | 13,906 | - |
| | \$ 6,701 | \$ 1,081 | \$ 87 | \$ 7,869 | \$ 1,054,476 | \$ 38,911 | \$ 1,101,256 | \$ 87 |

1. The "All other" class includes overdrafts and net deferred costs.

Credit Quality Indicators:

The Company categorizes loans into credit risk categories based on current financial information, overall debt service coverage, comparison against industry averages, historical payment experience, and current economic trends. This

analysis includes loans with outstanding balances or commitments greater than \$50,000 and excludes homogeneous loans such as home equity lines of credit and residential mortgages. Loans with a classified risk rating are reviewed quarterly regardless of size or loan type. The Company uses the following definitions for classified risk ratings:

Special Mention. Loans classified as special mention have a potential weakness that deserves management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan at some future date.

13

Table of Contents

Substandard. Loans classified as substandard are inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

Doubtful. Loans classified as doubtful have all the weaknesses inherent in those classified as substandard, with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.

Credits that are not covered by the definitions above are pass credits, which are not considered to be adversely rated.

Credit Quality Indicators by class of loans were as follows:

| September 30, 2014 | Pass | Special Mention | Substandard 1 | Doubtful | Total |
|------------------------------------|--------------|--------------------|---------------|----------|--------------|
| Commercial | \$ 106,620 | \$ 4,119 | \$ 4,251 | \$ - | \$ 114,990 |
| Real estate - commercial | | | | | |
| Owner occupied general purpose | 129,530 | 913 | 7,685 | - | 138,128 |
| Owner occupied special purpose | 151,663 | 12,558 | 6,142 | - | 170,363 |
| Non-owner occupied general purpose | 145,153 | 1,872 | 9,469 | - | 156,494 |
| Non-owner occupied special purpose | 76,267 | 8,143 | 1,472 | - | 85,882 |
| Retail Properties | 32,450 | 2,242 | - | - | 34,692 |
| Farm | 15,090 | - | - | - | 15,090 |
| Real estate - construction | | | | | |
| Homebuilder | 3,232 | - | - | - | 3,232 |
| Land | 1,684 | - | 209 | - | 1,893 |
| Commercial speculative | 11,815 | 540 | 3,504 | - | 15,859 |
| All other | 20,367 | - | 585 | - | 20,952 |
| Real estate - residential | | | | | |
| Investor | 126,879 | - | 3,407 | - | 130,286 |
| Owner occupied | 109,723 | - | 7,797 | - | 117,520 |
| Revolving and junior liens | 113,933 | 188 | 3,675 | - | 117,796 |
| Consumer | 3,141 | - | 1 | - | 3,142 |
| All other | 14,563 | - | - | - | 14,563 |
| Total | \$ 1,062,110 | \$ 30,575 | \$ 48,197 | \$ - | \$ 1,140,882 |

Edgar Filing: OLD SECOND BANCORP INC - Form 10-Q

| December 31, 2013 | Pass | Special Mention | Substandard 1 | Doubtful | Total |
|------------------------------------|------------|--------------------|---------------|----------|--------------|
| Commercial | \$ 96,371 | \$ 7,953 | \$ 481 | \$ - | \$ 104,805 |
| Real estate - commercial | | | | | |
| Owner occupied general purpose | 105,683 | 9,048 | 7,203 | - | 121,934 |
| Owner occupied special purpose | 162,586 | 1,968 | 7,905 | - | 172,459 |
| Non-owner occupied general purpose | 122,844 | 1,826 | 13,587 | - | 138,257 |
| Non-owner occupied special purpose | 59,674 | 9,840 | 4,472 | - | 73,986 |
| Retail Properties | 30,059 | 2,989 | 4,130 | - | 37,178 |
| Farm | 16,419 | - | - | - | 16,419 |
| Real estate - construction | | | | | |
| Homebuilder | 1,745 | 1,770 | 168 | - | 3,683 |
| Land | 4,436 | - | 209 | - | 4,645 |
| Commercial speculative | 7,674 | 3,561 | 1,913 | - | 13,148 |
| All other | 7,109 | 32 | 734 | - | 7,875 |
| Real estate - residential | | | | | |
| Investor | 135,136 | 3,407 | 9,750 | - | 148,293 |
| Owner occupied | 109,261 | - | 7,699 | - | 116,960 |
| Revolving and junior liens | 120,589 | 388 | 3,971 | - | 124,948 |
| Consumer | 2,759 | - | 1 | - | 2,760 |
| All other | 13,906 | - | - | - | 13,906 |
| Total | \$ 996,251 | \$ 42,782 | \$ 62,223 | \$ - | \$ 1,101,256 |

1 The substandard credit quality indicator includes both potential problem loans that are currently performing and nonperforming loans

Table of Contents

Impaired loans by class of loan were as follows:

| | As of September 30, 2014 | | | Nine Months Ended September 30, 2014 | |
|---|--------------------------|--------------------------------|----------------------|---|----------------------------------|
| | Recorded Investment | Unpaid Principal Balance | Related Allowance | Average Recorded Investment | Interest Income Recognized |
| With no related allowance recorded | | | | | |
| Commercial | \$ 1,645 | \$ 2,173 | \$ - | \$ 836 | \$ - |
| Commercial real estate | | | | | |
| Owner occupied general purpose | 7,176 | 7,840 | - | 4,860 | 81 |
| Owner occupied special purpose | 3,217 | 4,147 | - | 3,294 | - |
| Non-owner occupied general purpose | 7,065 | 8,052 | - | 6,246 | 45 |
| Non-owner occupied special purpose | 1,472 | 1,935 | - | 1,067 | - |
| Retail properties | - | - | - | 1,572 | - |
| Farm | - | - | - | - | - |
| Construction | | | | | |
| Homebuilder | 1,791 | 1,791 | - | 1,903 | 69 |
| Land | 209 | 312 | - | 209 | - |
| Commercial speculative | - | - | - | 369 | - |
| All other | 306 | 347 | - | 155 | - |
| Residential | | | | | |
| Investor | 2,553 | 3,538 | - | 4,269 | 32 |
| Owner occupied | 11,735 | 13,214 | - | 10,457 | 128 |
| Revolving and junior liens | 2,028 | 3,163 | - | 1,899 | 4 |
| Consumer | - | - | - | - | - |
| Total impaired loans with no recorded allowance | 39,197 | 46,512 | - | 37,136 | 359 |
| With an allowance recorded | | | | | |
| Commercial | - | - | - | - | - |
| Commercial real estate | | | | | |
| Owner occupied general purpose | - | - | - | 365 | - |
| Owner occupied special purpose | 585 | 676 | 167 | 2,443 | - |
| Non-owner occupied general purpose | - | - | - | 469 | - |
| Non-owner occupied special purpose | - | - | - | - | - |
| Retail properties | - | - | - | - | - |
| Farm | - | - | - | - | - |
| Construction | | | | | |
| Homebuilder | - | - | - | 84 | - |
| Land | - | - | - | - | - |
| Commercial speculative | - | - | - | 588 | - |
| All other | 279 | 312 | 107 | 357 | - |
| Residential | | | | | |
| Investor | 139 | 149 | 79 | 412 | - |
| Owner occupied | 259 | 394 | 59 | 912 | 15 |

Edgar Filing: OLD SECOND BANCORP INC - Form 10-Q

| | | | | | |
|--|-----------|-----------|--------|-----------|--------|
| Revolving and junior liens | 327 | 358 | 129 | 912 | - |
| Consumer | - | - | - | - | - |
| Total impaired loans with a recorded allowance | 1,589 | 1,889 | 541 | 6,542 | 15 |
| Total impaired loans | \$ 40,786 | \$ 48,401 | \$ 541 | \$ 43,678 | \$ 374 |

15

Table of Contents

Impaired loans by class of loans were as follows:

| | As of December 31, 2013 | | | Nine Months Ended September 30, 2013 | |
|---|-------------------------|--------------------------------|----------------------|---|----------------------------------|
| | Recorded Investment | Unpaid Principal Balance | Related Allowance | Average Recorded Investment | Interest Income Recognized |
| With no related allowance recorded | | | | | |
| Commercial | \$ 27 | \$ 34 | \$ - | \$ 113 | \$ - |
| Commercial real estate | | | | | |
| Owner occupied general purpose | 2,543 | 3,006 | - | 3,565 | 3 |
| Owner occupied special purpose | 3,371 | 4,117 | - | 5,913 | - |
| Non-owner occupied general purpose | 5,428 | 6,709 | - | 11,995 | 113 |
| Non-owner occupied special purpose | 661 | 919 | - | 457 | - |
| Retail properties | 3,144 | 3,811 | - | 6,918 | - |
| Farm | - | - | - | 1,259 | - |
| Construction | | | | | |
| Homebuilder | 2,016 | 2,016 | - | 3,597 | 120 |
| Land | 209 | 308 | - | 231 | - |
| Commercial speculative | 738 | 742 | - | 2,089 | - |
| All other | 4 | 35 | - | 188 | - |
| Residential | | | | | |
| Investor | 5,984 | 8,338 | - | 5,845 | - |
| Owner occupied | 9,179 | 10,451 | - | 9,606 | 151 |
| Revolving and junior liens | 1,771 | 2,313 | - | 1,668 | 5 |
| Consumer | - | - | - | 12 | - |
| Total impaired loans with no recorded allowance | 35,075 | 42,799 | - | 53,456 | 392 |
| With an allowance recorded | | | | | |
| Commercial | - | - | - | 283 | - |
| Commercial real estate | | | | | |
| Owner occupied general purpose | 730 | 792 | 264 | 974 | - |
| Owner occupied special purpose | 4,300 | 4,702 | 759 | 2,777 | - |
| Non-owner occupied general purpose | 939 | 1,030 | 129 | 1,481 | - |
| Non-owner occupied special purpose | - | - | - | - | - |
| Retail properties | - | - | - | 876 | - |
| Farm | - | - | - | - | - |
| Construction | | | | | |
| Homebuilder | 168 | 604 | 76 | 97 | - |
| Land | - | - | - | - | - |
| Commercial speculative | 1,175 | 1,808 | 17 | 2,971 | - |
| All other | 436 | 468 | 262 | 465 | - |
| Residential | | | | | |
| Investor | 684 | 913 | 160 | 3,263 | - |
| Owner occupied | 1,565 | 1,831 | 170 | 3,448 | 12 |

Edgar Filing: OLD SECOND BANCORP INC - Form 10-Q

| | | | | | |
|--|-----------|-----------|----------|-----------|--------|
| Revolving and junior liens | 1,498 | 1,848 | 558 | 1,527 | - |
| Consumer | - | - | - | - | - |
| Total impaired loans with a recorded allowance | 11,495 | 13,996 | 2,395 | 18,162 | 12 |
| Total impaired loans | \$ 46,570 | \$ 56,795 | \$ 2,395 | \$ 71,618 | \$ 404 |

Troubled debt restructurings (“TDRs”) are loans for which the contractual terms have been modified and both of these conditions exist: (1) there is a concession to the borrower and (2) the borrower is experiencing financial difficulties. Loans are restructured on a case-by-case basis during the loan collection process with modifications generally initiated at the request of the borrower. These modifications may include reduction in interest rates, extension of term, deferrals of principal, and other modifications. The Bank participates in the U.S. Department of the Treasury’s (the “Treasury”) Home Affordable Modification Program (“HAMP”) which gives qualifying homeowners an opportunity to refinance into more affordable monthly payments.

The specific allocation of the allowance for loan losses on a TDR is determined by either discounting the modified cash flows at the original effective rate of the loan before modification or is based on the underlying collateral value less costs to sell, if repayment of the loan is collateral-dependent. If the resulting amount is less than the recorded book value, the Bank either establishes a valuation allowance (i.e. specific reserve) as a component of the allowance for loan losses or charges off the impaired balance if it determines that such amount is a confirmed loss. This method is used consistently for all segments of the portfolio. The allowance for loan losses also includes an allowance based on a loss migration analysis for each loan category on loans that are not individually evaluated for specific impairment. All loans charged-off, including TDRs charged-off, are factored into this calculation by portfolio segment.

Table of Contents

TDRs that were modified during the period are as follows:

| | TDR Modifications Three Months Ended September 30, 2014 | | | TDR Modifications Nine Months Ended September 30, 2014 | | |
|---------------------------------|--|---|--|---|---|--|
| | # of contracts | Pre-modification recorded investment | Post-modification recorded investment | # of contracts | Pre-modification recorded investment | Post-modification recorded investment |
| Troubled debt restructurings | | | | | | |
| Real estate - commercial | | | | | | |
| Other1 | - | \$ - | \$ - | 2 | \$ 1,320 | \$ 1,118 |
| Real estate - residential | | | | | | |
| Investor | | | | | | |
| Other1 | 1 | 155 | 153 | 1 | 155 | 153 |
| Owner occupied | | | | | | |
| HAMP2 | - | - | - | 1 | 102 | 74 |
| Deferral3 | - | - | - | 2 | 344 | 226 |
| Revolving and junior liens | | | | | | |
| Other1 | 1 | 62 | 59 | 3 | 222 | 218 |
| | 2 | \$ 217 | \$ 212 | 9 | \$ 2,143 | \$ 1,789 |

| | TDR Modifications Three Months Ended September 30, 2013 | | | TDR Modifications Nine Months Ended September 30, 2013 | | |
|---------------------------------|--|---|--|---|---|--|
| | # of contracts | Pre-modification recorded investment | Post-modification recorded investment | # of contracts | Pre-modification recorded investment | Post-modification recorded investment |
| Troubled debt restructurings | | | | | | |
| Real estate - commercial | | | | | | |
| Deferral3 | - | \$ - | \$ - | 1 | \$ 610 | \$ 472 |

| | | | | | | |
|----------------------------|---|------|------|---|--------|--------|
| Real estate - residential | | | | | | |
| Owner occupied | | | | | | |
| Deferral ³ | - | - | - | 1 | 137 | 137 |
| Revolving and junior liens | | | | | | |
| Other ¹ | - | - | - | 1 | 30 | 29 |
| | - | \$ - | \$ - | 3 | \$ 777 | \$ 638 |

1 Other: Change of terms from bankruptcy court

2 HAMP: Home Affordable Modification Program

3 Deferral: Refers to the deferral of principal

TDRs are classified as being in default on a case-by-case basis when they fail to be in compliance with the modified terms. The following table presents TDRs that defaulted during the periods shown and were restructured within the 12 month period prior to default. There was no TDR default activity for the three and nine months ended September 30, 2014.

| Troubled debt restructurings that Subsequently Defaulted | TDR Default Activity Three Months Ended September 30, 2013 | | TDR Default Activity Nine Months Ended September 30, 2013 | |
|--|---|--|--|--|
| | # of contracts | Pre-modification outstanding recorded investment | # of contracts | Pre-modification outstanding recorded investment |
| Real estate - commercial | | | | |
| Owner occupied special purpose | 1 | \$ 610 | 1 | \$ 610 |
| Real estate - residential | | | | |
| Investor | - | - | 1 | 155 |
| Owner occupied | 1 | 175 | 1 | 175 |
| Revolving and junior liens | 1 | 30 | 1 | 30 |
| | 3 | \$ 815 | 4 | \$ 970 |

Table of Contents

Note 4 – Allowance for Loan Losses

Changes in the allowance for loan losses by segment of loans based on method of impairment for the three and nine months ended September 30, 2014, were as follows:

| Allowance for loan losses: | Commercial | Real Estate Commercial 1 | Real Estate Construction | Real Estate Residential | Consumer | Unallocated | Total |
|--|------------|--------------------------|--------------------------|-------------------------|----------|-------------|--------------|
| Three months ended September 30, 2014 | | | | | | | |
| Beginning balance | \$ 1,991 | \$ 13,228 | \$ 1,754 | \$ 2,373 | \$ 1,464 | \$ 3,046 | \$ 23,856 |
| Charge-offs | 512 | 545 | 1 | 925 | 174 | - | 2,157 |
| Recoveries | 6 | 878 | 3 | 646 | 98 | - | 1,631 |
| Provision (release) | 41 | (744) | 141 | 7 | 16 | 539 | - |
| Ending balance | \$ 1,526 | \$ 12,817 | \$ 1,897 | \$ 2,101 | \$ 1,404 | \$ 3,585 | \$ 23,330 |
| Nine months ended September 30, 2014 | | | | | | | |
| Beginning balance | \$ 2,250 | \$ 16,763 | \$ 1,980 | \$ 2,837 | \$ 1,439 | \$ 2,012 | \$ 27,281 |
| Charge-offs | 519 | 1,634 | 174 | 2,752 | 423 | - | 5,502 |
| Recoveries | 56 | 1,106 | 507 | 1,585 | 297 | - | 3,551 |
| (Release) provision | (261) | (3,418) | (416) | 431 | 91 | 1,573 | (2,000) |
| Ending balance | \$ 1,526 | \$ 12,817 | \$ 1,897 | \$ 2,101 | \$ 1,404 | \$ 3,585 | \$ 23,330 |
| Ending balance: | | | | | | | |
| Individually evaluated for impairment | \$ - | \$ 167 | \$ 107 | \$ 267 | \$ - | \$ - | \$ 541 |
| Ending balance: | | | | | | | |
| Collectively evaluated for impairment | \$ 1,526 | \$ 12,650 | \$ 1,790 | \$ 1,834 | \$ 1,404 | \$ 3,585 | \$ 22,789 |
| Financing receivables: | | | | | | | |
| Ending balance | \$ 114,990 | \$ 600,649 | \$ 41,936 | \$ 365,602 | \$ 3,142 | \$ 14,563 | \$ 1,140,882 |
| Ending balance: | | | | | | | |
| Individually evaluated for impairment | \$ 1,645 | \$ 19,515 | \$ 2,585 | \$ 17,041 | \$ - | \$ - | \$ 40,786 |
| Ending balance: | | | | | | | |
| Collectively evaluated for impairment | \$ 113,345 | \$ 581,134 | \$ 39,351 | \$ 348,561 | \$ 3,142 | \$ 14,563 | \$ 1,100,096 |

1 As of September 30, 2014, this segment consisted of performing loans that included a higher risk pool of loans rated as substandard that totaled \$7.1 million. The amount of general allocation that was estimated for that portion of these

Edgar Filing: OLD SECOND BANCORP INC - Form 10-Q

performing substandard rated loans was \$1.2 million at September 30, 2014.

Changes in the allowance for loan losses by segment of loans based on method of impairment for the three and nine months ended September 30, 2013, were as follows:

| Allowance for loan losses: | Commercial | Real Estate Commercial | Real Estate Construction | Real Estate Residential | Consumer | Unallocated | Total |
|--|------------|------------------------|--------------------------|-------------------------|----------|-------------|--------------|
| Three Months Ended September 30, 2013 | | | | | | | |
| Beginning balance | \$ 3,332 | \$ 18,097 | \$ 2,690 | \$ 5,021 | \$ 1,372 | \$ 4,530 | \$ 35,042 |
| Charge-offs | 29 | 851 | 53 | 3,594 | 168 | - | 4,695 |
| Recoveries | 60 | 523 | 15 | 209 | 143 | - | 950 |
| (Release) provision | (469) | (1,354) | (252) | 1,352 | 162 | (1,189) | (1,750) |
| Ending balance | \$ 2,894 | \$ 16,415 | \$ 2,400 | \$ 2,988 | \$ 1,509 | \$ 3,341 | \$ 29,547 |
| Nine Months Ended September 30, 2013 | | | | | | | |
| Beginning balance | \$ 4,517 | \$ 20,100 | \$ 3,837 | \$ 4,535 | \$ 1,178 | \$ 4,430 | \$ 38,597 |
| Charge-offs | 308 | 2,377 | 951 | 5,193 | 474 | - | 9,303 |
| Recoveries | 104 | 3,752 | 1,265 | 792 | 390 | - | 6,303 |
| (Release) provision | (1,419) | (5,060) | (1,751) | 2,854 | 415 | (1,089) | (6,050) |
| Ending balance | \$ 2,894 | \$ 16,415 | \$ 2,400 | \$ 2,988 | \$ 1,509 | \$ 3,341 | \$ 29,547 |
| Ending balance: | | | | | | | |
| Individually evaluated for impairment | \$ - | \$ 750 | \$ 412 | \$ 988 | \$ - | \$ - | \$ 2,150 |
| Ending balance: | | | | | | | |
| Collectively evaluated for impairment | \$ 2,894 | \$ 15,665 | \$ 1,988 | \$ 2,000 | \$ 1,509 | \$ 3,341 | \$ 27,397 |
| Financing receivables: | | | | | | | |
| Ending balance | \$ 98,026 | \$ 554,874 | \$ 30,996 | \$ 376,859 | \$ 2,570 | \$ 14,315 | \$ 1,077,640 |
| Ending balance: | | | | | | | |
| Individually evaluated for impairment | \$ 29 | \$ 24,849 | \$ 7,698 | \$ 21,675 | \$ - | \$ - | \$ 54,251 |
| Ending balance: | | | | | | | |
| Collectively evaluated for impairment | \$ 97,997 | \$ 530,025 | \$ 23,298 | \$ 355,184 | \$ 2,570 | \$ 14,315 | \$ 1,023,389 |

1 As of September 30, 2013, this segment consisted of performing loans that included a higher risk pool of loans rated as substandard that totaled \$14.4 million. The amount of general allocation that was estimated for that portion of these performing substandard rated loans was \$2.7 million at September 30, 2013.

18

Table of Contents

Note 5 – Other Real Estate Owned

Details related to the activity in the other real estate owned (“OREO”) portfolio, net of valuation reserve, for the periods presented are itemized in the following table:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|-------------------------------------|-----------|------------------------------------|-----------|
| | 2014 | 2013 | 2014 | 2013 |
| Other real estate owned | | | | |
| Balance at beginning of period | \$ 39,232 | \$ 59,465 | \$ 41,537 | \$ 72,423 |
| Property additions | 4,277 | 3,015 | 13,620 | 14,196 |
| Property improvements | 506 | 10 | 637 | 60 |
| Less: | | | | |
| Property disposals, net of gains/losses | 1,618 | 11,463 | 12,136 | 30,928 |
| Period valuation adjustments | 1,520 | 1,961 | 2,781 | 6,685 |
| Balance at end of period | \$ 40,877 | \$ 49,066 | \$ 40,877 | \$ 49,066 |

Activity in the valuation allowance was as follows:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---------------------------------|-------------------------------------|-----------|------------------------------------|-----------|
| | 2014 | 2013 | 2014 | 2013 |
| Balance at beginning of period | \$ 17,873 | \$ 30,487 | \$ 22,284 | \$ 31,454 |
| Provision for unrealized losses | 1,520 | 1,961 | 2,781 | 6,537 |
| Reductions taken on sales | (348) | (7,571) | (5,431) | (13,305) |
| Other adjustments | - | (290) | (589) | (99) |
| Balance at end of period | \$ 19,045 | \$ 24,587 | \$ 19,045 | \$ 24,587 |

Expenses related to OREO, net of lease revenue includes:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--------------------|-------------------------------------|----------|------------------------------------|------------|
| | 2014 | 2013 | 2014 | 2013 |
| Gain on sales, net | \$ (201) | \$ (608) | \$ (610) | \$ (1,175) |

Edgar Filing: OLD SECOND BANCORP INC - Form 10-Q

| | | | | |
|---------------------------------|----------|----------|----------|----------|
| Provision for unrealized losses | 1,520 | 1,961 | 2,781 | 6,537 |
| Operating expenses | 884 | 1,500 | 3,132 | 4,555 |
| Less: | | | | |
| Lease revenue | 196 | 309 | 638 | 974 |
| | \$ 2,007 | \$ 2,544 | \$ 4,665 | \$ 8,943 |

Note 6 – Deposits

Major classifications of deposits were as follows:

| | September 30, 2014 | December 31, 2013 |
|--|--------------------|-------------------|
| Noninterest bearing demand | \$ 380,687 | \$ 373,389 |
| Savings | 236,289 | 228,589 |
| NOW accounts | 315,665 | 297,852 |
| Money market accounts | 296,418 | 309,859 |
| Certificates of deposit of less than \$100,000 | 256,452 | 288,345 |
| Certificates of deposit of \$100,000 or more | 171,244 | 184,094 |
| | \$ 1,656,755 | \$ 1,682,128 |

Table of Contents

Note 7 – Borrowings

The following table is a summary of borrowings as of September 30, 2014, and December 31, 2013. Junior subordinated debentures are discussed in detail in Note 8:

| | September 30, 2014 | December 31, 2013 |
|---|--------------------|-------------------|
| Securities sold under repurchase agreements | \$ 29,438 | \$ 22,560 |
| FHLBC advances | 40,000 | 5,000 |
| Junior subordinated debentures | 58,378 | 58,378 |
| Subordinated debt | 45,000 | 45,000 |
| Notes payable and other borrowings | 500 | 500 |
| | \$ 173,316 | \$ 131,438 |

The Company enters into deposit sweep transactions where the transaction amounts are secured by pledged securities. These transactions consistently mature within 1 to 90 days from the transaction date and are governed by sweep repurchase agreements. All sweep repurchase agreements are treated as financings secured by U.S. government agencies and collateralized mortgage-backed securities and have a carrying amount of \$29.4 million at September 30, 2014, and \$22.6 million at December 31, 2013. The fair value of the pledged collateral was \$43.4 million and \$39.2 million at September 30, 2014 and December 31, 2013, respectively. At September 30, 2014, there were no customers with secured balances exceeding 10% of stockholders' equity.

The Company's borrowings at the FHLBC require the Bank to be a member and invest in the stock of the FHLBC. Total borrowings are generally limited to the lower of 35% of total assets or 60% of the book value of certain mortgage loans. As of September 30, 2014, the Bank had taken an advance of \$40.0 million on the FHLBC stock valued at \$4.3 million, collateralized securities with a fair value of \$93.1 million and loans with a principal balance of \$52.4 million, which carry a combined collateral value of \$91.2 million. The Company has excess collateral of \$49.9 million available to secure borrowings.

One of the Company's most significant borrowing relationships continued to be the \$45.5 million credit facility with a correspondent bank. That credit began in January 2008 and was originally composed of a \$30.5 million senior debt facility, which included \$500,000 in term debt, and \$45.0 million of subordinated debt. The subordinated debt and the term debt portion of the senior debt facility mature on March 31, 2018. The interest rate on the senior debt facility resets quarterly and at the Company's option, is based on, either the lender's prime rate or three-month LIBOR plus 90 basis points. The interest rate on the subordinated debt resets quarterly, and is equal to three-month LIBOR plus 150 basis points. The Company had no principal outstanding balance on the senior line of credit portion of the senior debt facility when it matured and was terminated. The Company had \$500,000 in principal outstanding in term debt and \$45.0 million in principal outstanding in subordinated debt at the end of both September 30, 2014, and December 31, 2013. The term debt is secured by all of the outstanding capital stock of the Bank. The Company has

made all required interest payments on the outstanding principal balance on a timely basis.

The credit facility agreement contains usual and customary provisions regarding acceleration of the senior debt upon the occurrence of an event of default by the Company under the senior debt agreement. The senior debt agreement also contains certain customary representations and warranties, and financial covenants. At September 30, 2014, the Company was out of compliance with two of the financial covenants contained within the credit agreement. As of June 30, 2014, the Company reported being out of compliance on one of the financial covenants contained in the referenced credit agreement. Prior to 2013, the Company had been out of compliance with two of the financial covenants. The agreement provides that noncompliance is an event of default and as the result of the Company's failure to comply with a financial covenant, the lender may (i) terminate all commitments to extend further credit, (ii) increase the interest rate on the revolving line of the term debt by 200 basis points, (iii) declare the senior debt immediately due and payable and (iv) exercise all of its rights and remedies at law, in equity and/or pursuant to any or all collateral documents, including foreclosing on the collateral. The total outstanding principal of the senior debt is the \$500,000 in term debt. Because the subordinated debt is treated as Tier 2 capital for regulatory capital purposes, the senior debt agreement does not provide the lender with any rights of acceleration or other remedies with regard to the subordinated debt upon an event of default caused by the Company's failure to comply with a financial covenant. Specifically, the covenants that were not met address the Bank's return on average assets and nonperforming assets as a percentage of the Bank's primary capital, when calculated per the debt agreement.

Note 8 – Junior Subordinated Debentures

The Company completed the sale of \$27.5 million of cumulative trust preferred securities by its unconsolidated subsidiary, Old Second Capital Trust I in June 2003. An additional \$4.1 million of cumulative trust preferred securities were sold in July 2003. The trust preferred securities may remain outstanding for a 30-year term but, subject to regulatory approval, can be called in whole or in part by the Company after June 30, 2008. When not in deferral, distributions on the securities are payable quarterly at an annual rate of 7.80%. The Company issued a new \$32.6 million subordinated debenture to Old Second Capital Trust I in return for the aggregate net proceeds of this trust preferred offering. The interest rate and payment frequency on the debenture are equivalent to the cash distribution basis on the trust preferred securities.

Table of Contents

The Company issued an additional \$25.0 million of cumulative trust preferred securities through a private placement completed by an additional, unconsolidated subsidiary, Old Second Capital Trust II, in April 2007. These trust preferred securities also mature in 30 years, but subject to the aforementioned regulatory approval, can be called in whole or in part on a quarterly basis commencing June 15, 2017. The quarterly cash distributions on the securities are fixed at 6.77% through June 15, 2017 and float at 150 basis points over three-month LIBOR thereafter. The Company issued a new \$25.8 million subordinated debenture to the Old Second Capital Trust II in return for the aggregate net proceeds of this trust preferred offering. The interest rate and payment frequency on the debenture are equivalent to the cash distribution basis on the trust preferred securities.

Under the terms of the subordinated debentures issued to each of Old Second Capital Trust I and II, the Company is allowed to defer payments of interest for 20 quarterly periods without default or penalty, but such amounts continue to accrue. Also during a deferral period, the Company generally may not pay cash dividends on or repurchase its common stock or preferred stock, including the Series B Fixed Rate Cumulative Perpetual Preferred Stock (the "Series B Stock"), as discussed in Note 15. In August of 2010, the Company elected to defer regularly scheduled interest payments on the \$58.4 million of junior subordinated debentures. Because of the deferral on the subordinated debentures, the trusts deferred regularly scheduled dividends on the trust preferred securities. On April 21, 2014, the Company paid all outstanding interest, which totaled \$19.7 million, on the trust preferred securities to the trustees for payment to holders as of the next record date set forth in the indentures and terminated the deferral period. The Company paid \$1.1 million of interest due in the third quarter of 2014. Both of the debentures issued by the Company are disclosed on the Consolidated Balance Sheet as junior subordinated debentures and the related interest expense for each issuance is included in the Consolidated Statements of of Operations.

Note 9 – Equity Compensation Plans

There are stock-based awards outstanding under the Company's 2008 Equity Incentive Plan (the "2008 Plan") and the Company's 2014 Equity Incentive Plan (the "2014 Plan," and together with the 2008 Plan, the "Plans"). The 2014 Plan was approved at the 2014 annual meeting of stockholders. Following approval of the 2014 Plan, no further awards will be granted under the 2008 Plan or any other Company equity compensation plan. A maximum of 375,000 shares may be issued under the 2014 Plan. The Plan authorizes the granting of qualified stock options, non-qualified stock options, restricted stock, restricted stock units, and stock appreciation rights. Awards may be granted to selected directors and officers or employees under the 2014 Plan at the discretion of the Compensation Committee of the Company's Board of Directors. As of September 30, 2014, 210,500 shares remained available for issuance under the 2014 Plan.

Total compensation cost that has been charged for the plans was \$189,000 in the first nine months of 2014 and \$123,000 in the first nine months of 2013.

There were no stock options granted in the third quarter of 2014 or 2013. All stock options are granted for a term of ten years. There were no stock options exercised during the third quarter of 2014 or 2013. There is no unrecognized compensation cost related to unvested stock options as all stock options of the Company's common stock have vested.

A summary of stock option activity in the Plans for the nine months ending September 30, 2014, is as follows:

| | Shares | Weighted Average Exercise Price | Weighted Average Remaining Contractual Term (years) | Aggregate Intrinsic Value |
|------------------------------|---------|--|---|------------------------------|
| Beginning outstanding | 325,500 | \$ 29.56 | | |
| Canceled | - | - | | |
| Ending outstanding | 325,500 | \$ 29.56 | 1.8 | \$ - |
| Exercisable at end of period | 325,500 | \$ 29.56 | 1.8 | \$ - |

Generally, restricted stock and restricted stock units granted under the Plans vest three years from the grant date, but the Compensation Committee of the Company's Board of Directors has discretionary authority to change some terms including the amount of time until the vest date.

Awards under the 2008 Plan will become fully vested upon a merger or change in control of the Company. Under the 2014 Plan, upon a change in control of the Company, if (i) the 2014 Plan is not an obligation of the successor entity following the change in control, or (ii) the 2014 Plan is an obligation of the successor entity following the change in control and the participant incurs an involuntary termination, then the stock options, stock appreciation rights, stock awards and cash incentive awards under the 2014 Plan will become fully exercisable and vested. Performance-based awards generally will vest based upon the level of achievement of the applicable performance measures through the change in control.

Table of Contents

The Company granted restricted stock under its equity compensation plans beginning in 2005 and it began granting restricted stock units in February 2009. Restricted stock awards under the Plans generally entitle holders to voting and dividend rights upon grant and are subject to forfeiture until certain restrictions have lapsed including employment for a specific period. Restricted stock units under the Plans are also subject to forfeiture until certain restrictions have lapsed including employment for a specific period, and generally entitle holders to receive dividend equivalents during the restricted period but do not entitle holders to voting rights until the restricted period ends and shares are transferred in connection with the units.

There were no restricted awards issued under the Plans during the third quarter of 2014 and 184,500 restricted awards issued during the nine months ending September 30, 2014. There were no restricted awards issued during the third quarter of 2013 and 155,500 restricted awards issued for the nine months ending September 30, 2013. Compensation expense is recognized over the vesting period of the restricted award based on the market value of the award on the issue date.

A summary of changes in the Company's unvested restricted awards for the nine months ending September 30, 2014, is as follows:

| | September 30, 2014 | |
|---------------------------|---|---|
| | Restricted Stock Shares and Units | Weighted Average Grant Date Fair Value |
| Nonvested at January 1 | 185,500 | \$ 2.95 |
| Granted | 184,500 | 4.82 |
| Vested | (25,000) | 2.06 |
| Forfeited | (20,000) | 1.74 |
| Nonvested at September 30 | 325,000 | \$ 4.15 |

Total unrecognized compensation cost of restricted awards was \$1.0 million as of September 30, 2014, which is expected to be recognized over a weighted-average period of 2.48 years. Total unrecognized compensation cost of restricted awards was \$411,000 as of September 30, 2013, which was expected to be recognized over a weighted-average period of 2.46 years.

Note 10 – Earnings Per Share

Edgar Filing: OLD SECOND BANCORP INC - Form 10-Q

The earnings per share – both basic and diluted – are included below as of September 30 (in thousands except for share data):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|-------------------------------------|------------|------------------------------------|------------|
| | 2014 | 2013 | 2014 | 2013 |
| Basic earnings per share: | | | | |
| Weighted-average common shares outstanding | 29,442,508 | 13,885,884 | 23,905,205 | 13,947,606 |
| Weighted-average common shares less stock based awards | 29,442,508 | 13,870,884 | 23,902,403 | 13,895,136 |
| Weighted-average common shares stock based awards | 325,000 | 231,152 | 225,232 | 217,107 |
| Net income from operations | \$ 2,924 | \$ 72,924 | \$ 7,147 | \$ 81,872 |
| Gain on preferred stock redemption | - | - | (1,348) | - |
| Preferred stock dividends and accretion, net of dividends waived | 1,065 | 1,323 | (1,448) | 3,917 |
| Net earnings available to common stockholders | 1,859 | 71,601 | 9,943 | 77,955 |
| Undistributed earnings | 1,859 | 71,601 | 9,943 | 77,955 |
| Basic earnings per share common undistributed earnings | 0.06 | 5.08 | 0.41 | 5.52 |
| Basic earnings per share | 0.06 | 5.08 | 0.41 | 5.52 |
| Diluted earnings per share: | | | | |
| Weighted-average common shares outstanding | 29,442,508 | 13,885,884 | 23,905,205 | 13,947,606 |
| Dilutive effect of nonvested restricted awards ¹ | 325,000 | 216,152 | 222,430 | 164,637 |
| Diluted average common shares outstanding | 29,767,508 | 14,102,036 | 24,127,635 | 14,112,243 |
| Net earnings available to common stockholders | \$ 1,859 | \$ 71,601 | \$ 9,943 | \$ 77,955 |
| Diluted earnings per share | \$ 0.06 | \$ 5.08 | \$ 0.41 | \$ 5.52 |

Number of antidilutive options excluded from the diluted earnings per share calculation 1,140,839 1,224,839 1,140,839 1,224,839

¹ Includes the common stock equivalents for restricted share rights that are dilutive.

Table of Contents

The above earnings per share calculation did not include a warrant for 815,339 shares of common stock that was outstanding as of September 30, 2014, and September 30, 2013 because the warrant was anti-dilutive. Of note, the warrant was sold at auction by the Treasury in June 2013 to a third party investor.

The Company completed the redemption of 25,669 shares of its Series B Stock in the second quarter of 2014. As previously disclosed, the Company completed a public offering of 15,525,000 shares of common stock in April of 2014. Net proceeds of over \$64.0 million were used to pay the accrued but unpaid interest on the Company's trust preferred securities or junior subordinated debentures discussed in Note 8, the accumulated but unpaid dividends on the Series B Stock and to complete this redemption. The amount remaining after the completion of these transactions was retained at the Company for use in addressing general corporate matters. The redemption price for such Series B Stock was 94.75% of the liquidation value of the Series B Stock provided that the holders of shares entered into agreements to forebear payment of dividends due and to waive any rights to such dividend upon redemption. The Company redeemed all shares of Series B Stock held by directors of the Company on the same terms.

Note 11 – Regulatory & Capital Matters

The Bank is subject to the risk-based capital regulatory guidelines, which include the methodology for calculating the risk-weighted Bank assets, developed by the Office of the Comptroller of the Currency (the "OCC") and the other bank regulatory agencies. In connection with the current economic environment, the Bank's current level of nonperforming assets and the risk-based capital guidelines, the Bank's board of directors has determined that the Bank should maintain a Tier 1 leverage capital ratio at or above eight percent (8%) and a total risk-based capital ratio at or above twelve percent (12%). The Bank currently exceeds those thresholds.

The Bank exceeded both board of directors' capital ratio objectives. At September 30, 2014, the Bank's Tier 1 capital leverage ratio was 11.67%, up 70 basis points from December 31, 2013, and well above the 8.00% objective. The Bank's total capital ratio was 18.47%, up 43 basis points from December 31, 2013, and also well above the objective of 12.00%.

On July 22, 2011, the Company entered into a Written Agreement with the Reserve Bank designed to maintain the financial soundness of the Company. Pursuant to the Written Agreement, the Company took certain actions and operated in compliance with the Written Agreement's provisions during its term. On January 17, 2014, the Reserve Bank terminated the Written Agreement. Although the Written Agreement has been terminated, the Company expects that it will continue to seek approval from the Reserve Bank prior to paying any dividends on its capital stock and incurring any additional indebtedness.

Bank holding companies are required to maintain minimum levels of capital in accordance with capital guidelines implemented by the Board of Governors of the Federal Reserve System. The general bank and holding company

capital adequacy guidelines are shown in the accompanying table, as are the capital ratios of the Company and the Bank, as of September 30, 2014, and December 31, 2013. The Company's total risk-based capital ratio has been adjusted to correctly account for the Company's subordinated debt, a portion of which was excluded from Tier 2 capital because the subordinated debt is within five years of maturity. This change has also been made in all relevant prior quarters and has resulted in an immaterial reduction in the Company's total risk-based capital ratio for those periods. The reduction in regulatory capital amounts and ratios has no impact on the Company's historical consolidated financial statements or stockholders' equity, which were stated in accordance with GAAP.

The Company completed the redemption of certain of its Series B Fixed Rate Cumulative Preferred Stock (the "Series B Stock") in the second quarter, 2014. The Company completed a public offering of common stock in April. Net proceeds of over \$64.0 million were used to pay the accrued but unpaid interest on trust preferred securities, the accumulated but unpaid dividends on the Series B Stock and to complete this redemption. All ratios for September 30, 2014 reflect these changes in the Company's capital.

At September 30, 2014, the Company, on a consolidated basis, exceeded the minimum thresholds to be considered "adequately capitalized" under current regulatory defined capital ratios. The Company and the Bank are subject to regulatory capital requirements administered by federal banking agencies.

Table of Contents

Capital levels and industry defined regulatory minimum required levels:

| | Actual Amount | Ratio | Minimum Required for Capital Adequacy Purposes | | Minimum Required to be Well Capitalized 1 | |
|--|------------------|---------|--|--------|---|---------|
| | | | Amount | Ratio | Amount | Ratio |
| September 30, 2014 | | | | | | |
| Total capital to risk weighted assets | | | | | | |
| Consolidated | \$ 234,500 | 17.56 % | \$ 106,834 | 8.00 % | N/A | N/A |
| Old Second Bank | 246,873 | 18.47 | 106,929 | 8.00 | \$ 133,662 | 10.00 % |
| Tier 1 capital to risk weighted assets | | | | | | |
| Consolidated | 190,724 | 14.28 | 53,424 | 4.00 | N/A | N/A |
| Old Second Bank | 230,087 | 17.22 | 53,446 | 4.00 | 80,170 | 6.00 |
| Tier 1 capital to average assets | | | | | | |
| Consolidated | 190,724 | 9.68 | 78,812 | 4.00 | N/A | N/A |
| Old Second Bank | 230,087 | 11.67 | 78,864 | 4.00 | 98,581 | 5.00 |
| December 31, 2013 | | | | | | |
| Total capital to risk weighted assets | | | | | | |
| Consolidated | \$ 191,139 | 15.16 % | \$ 100,865 | 8.00 % | N/A | N/A |
| Old Second Bank | 227,467 | 18.04 | 100,872 | 8.00 | \$ 126,090 | 10.00 % |
| Tier 1 capital to risk weighted assets | | | | | | |
| Consolidated | 134,199 | 10.65 | 50,403 | 4.00 | N/A | N/A |
| Old Second Bank | 211,568 | 16.78 | 50,433 | 4.00 | 75,650 | 6.00 |
| Tier 1 capital to average assets | | | | | | |
| Consolidated | 134,199 | 6.96 | 77,126 | 4.00 | N/A | N/A |
| Old Second Bank | 211,568 | 10.97 | 77,144 | 4.00 | 96,430 | 5.00 |

1 The Bank exceeded the general minimum regulatory requirements to be considered “well capitalized”.

The Company’s credit facility with Bank of America includes \$45.0 million in subordinated debt. That debt obligation qualifies at 60% and 80% of the original amount for Tier 2 regulatory capital at September 30, 2014 and December 31, 2013, respectively. In addition, the trust preferred securities continue to qualify as Tier 1 regulatory capital, and the Company treats the maximum amount of this security type allowable under regulatory guidelines as Tier 1 capital. As of September 30, 2014 all \$56.6 million of the trust preferred proceeds qualified as Tier 1 regulatory capital. As of December 31, 2013, trust preferred proceeds of \$51.6 million qualified as Tier 1 regulatory capital and \$5.0 million qualified as Tier 2 regulatory capital. All of the Series B Stock qualified as Tier 1 regulatory capital as of September 30, 2014, and December 31, 2013.

Dividend Restrictions and Deferrals

In addition to the above requirements, banking regulations and capital guidelines generally limit the amount of dividends that may be paid by a Bank without prior regulatory approval. Under these regulations, the amount of dividends that may be paid in any calendar year is limited to the current year's profits, combined with the retained profit of the previous two years, subject to the capital requirements described above. The Bank has the ability and the authority to pay dividends to the Company to pay debt and to meet preferred dividend requirements.

As discussed in Note 8, as of September 30, 2014, the Company had \$58.4 million of junior subordinated debentures held by two statutory business trusts that it controls. The Company has the right to defer interest payments on the debentures for a period of up to 20 consecutive quarters, and elected to begin such a deferral in August 2010. However, all deferred interest must be paid before the Company may pay dividends on its common stock. In the second quarter of 2014, the Company terminated the deferral period and paid all accumulated and unpaid interest on the junior subordinated debentures which totaled \$19.7 million. The Company is currently paying interest as it comes due and \$1.1 million was paid in the third quarter of 2014.

Furthermore, as with the debentures discussed above, the Company is prohibited from paying dividends on its common stock unless it has fully paid all deferred dividends on the Series B Stock. In August 2010, it also began to defer the payment of dividends on such Series B Stock. Therefore, in addition to paying all the accrued and unpaid distributions on the debentures set forth above, the Company must also fully pay all deferred and unpaid dividends on the Series B Stock before it may reinstate the payment of dividends on the common stock.

On April 15, 2014, the Company declared a dividend of approximately \$15.8 million on its Series B Stock to stockholders of record on May 1, 2014. Series B Stock dividends of \$10.3 million were paid on May 15, 2014. The Company is currently paying dividends as they come due and \$1.1 million paid was paid on August 15, 2014.

Table of Contents

On April 28, 2014, the Company redeemed 25,669 shares of the Series B Stock from certain holders, which included certain of the Company's directors, at a redemption price of 94.75% of the per share liquidation value, or \$947.50 per share, for a total price of approximately \$24.3 million. The Company paid \$22.9 million to a large private investor and an additional \$1.4 million to Company directors for these purchases. The holders of such shares waived their rights to any dividends on the Series B Stock, and such holders did not receive any part of the declared dividend on the Series B Stock. In May, the Company paid \$10.3 million in Series B Stock dividends. In the second quarter, the Company also recognized benefit from \$5.4 million in net income available to common stockholders reflecting both reversal of dividends previously accrued as well as dividends accumulated but not accrued by the Company and waived by holders upon redemption.

Further detail on the junior subordinated debentures, the Series B Stock and the deferral of interest and dividends thereon is described in Notes 8 and 15.

Note 12 – Fair Value Option and Fair Value Measurements

Fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. The fair value hierarchy established by the Company also requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. Three levels of inputs that may be used to measure fair value are:

Level 1: Quoted prices (unadjusted) for identical assets or liabilities in active markets that the Company has the ability to access as of the measurement date.

Level 2: Significant observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities, quoted prices in markets that are not active, and other inputs that are observable or can be corroborated by observable market data.

Level 3: Significant unobservable inputs that reflect a company's own view about the assumptions that market participants would use in pricing an asset or liability.

Transfers between levels are deemed to have occurred at the end of the reporting period. For the quarters ended September 30, 2014, and 2013 there were no significant transfers between levels.

Except for auction rate asset-backed securities, the majority of securities (available-for-sale and held-to-maturity) are valued by external pricing services or dealer market participants and are classified in Level 2 of the fair value hierarchy. Both market and income valuation approaches are utilized. Quarterly, the Company evaluates the methodologies used by the external pricing services or dealer market participants to develop the fair values to determine whether the results of the valuations are representative of an exit price in the Company's principal markets and an appropriate representation of fair value. The Company uses the following methods and significant assumptions to estimate fair value:

- Government-sponsored agency debt securities are primarily priced using available market information through processes such as benchmark curves, market valuations of like securities, sector groupings and matrix pricing.
- Other government-sponsored agency securities, MBS and some of the actively traded real estate mortgage investment conduits and collateralized mortgage obligations are priced using available market information including benchmark yields, prepayment speeds, spreads, volatility of similar securities and trade date.
- State and political subdivisions are largely grouped by characteristics (e.g., geographical data and source of revenue in trade dissemination systems). Because some securities are not traded daily and due to other grouping limitations, active market quotes are often obtained using benchmarking for like securities.
- During 2013, asset-backed auction rate securities were acquired and priced using data from dealer market participants until December 31, 2013. At December 31, 2013, to present and including asset-backed auction rate securities acquired in 2014, the Company utilized pricing data from a nationally recognized valuation firm providing specialized securities valuation services. Therefore, the valuations of auction rate asset-backed securities are considered Level 3 valuations.
- During the third quarter of 2014, asset-backed collateralized loan obligations were acquired and priced using data from a pricing matrix support by our bond accounting service provider and are therefore considered Level 2 valuations.
- Residential mortgage loans eligible for sale in the secondary market are carried at fair market value. The fair value of loans held-for-sale is determined using quoted secondary market prices.
- Lending related commitments to fund certain residential mortgage loans, e.g. residential mortgage loans with locked interest rates to be sold in the secondary market and forward commitments for the future delivery of mortgage loans to third party investors as well as forward commitments for future delivery of MBS are considered derivatives. Fair values are estimated based on observable changes in mortgage interest rates including prices for MBS from the date of the commitment and do not typically involve significant judgments by management.
- The fair value of mortgage servicing rights is based on a valuation model that calculates the present value of estimated net servicing income. The valuation model incorporates assumptions that market participants would use in estimating future net

Table of Contents

servicing income to derive the resultant value. The Company is able to compare the valuation model inputs, such as the discount rate, prepayment speeds, weighted average delinquency and foreclosure/bankruptcy rates to widely available published industry data for reasonableness.

- Interest rate swap positions, both assets and liabilities, are based on valuation pricing models using an income approach reflecting readily observable market parameters such as interest rate yield curves.
- Both the credit valuation reserve on current interest rate swap positions and on receivables related to unwound customer interest rate swap positions were determined based upon management's estimate of the amount of credit risk exposure, including by available collateral protection and/or by utilizing an estimate related to a probability of default as indicated in the Bank credit policy. Such adjustments would result in a Level 3 classification.
- The fair value of impaired loans with specific allocations of the allowance for loan losses is essentially based on recent real estate appraisals. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are made in the appraisal process by the appraisers to reflect differences between the available comparable sales and income data. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value.
- Nonrecurring adjustments to certain commercial and residential real estate properties classified as OREO are measured at the lower of carrying amount or fair value, less costs to sell. Fair values are based on third party appraisals of the property, resulting in a Level 3 classification. In cases where the carrying amount exceeds the fair value, less costs to sell, an impairment loss is recognized.

Assets and Liabilities Measured at Fair Value on a Recurring Basis:

The tables below present the balance of assets and liabilities at September 30, 2014, and December 31, 2013, respectively, measured by the Company at fair value on a recurring basis:

| | September 30, 2014 | | | Total |
|---|--------------------|------------|-----------|------------|
| | Level 1 | Level 2 | Level 3 | |
| Assets: | | | | |
| Investment securities available-for-sale | | | | |
| U.S. Treasury | \$ 1,532 | \$ - | \$ - | \$ 1,532 |
| U.S. government agencies | - | 1,638 | - | 1,638 |
| States and political subdivisions | - | 13,754 | 125 | 13,879 |
| Corporate Bonds | - | 30,781 | - | 30,781 |
| Collateralized mortgage obligations | - | 28,417 | - | 28,417 |
| Asset-backed securities | - | 109,017 | 83,781 | 192,798 |
| Collateralized loan obligations | - | 93,198 | - | 93,198 |
| Loans held-for-sale | - | 3,422 | - | 3,422 |
| Mortgage servicing rights | - | - | 5,640 | 5,640 |
| Other assets (Interest rate swap agreements net of swap credit valuation) | - | 42 | - | 42 |
| Other assets (Mortgage banking derivatives) | - | 266 | - | 266 |
| Total | \$ 1,532 | \$ 280,535 | \$ 89,546 | \$ 371,613 |

Edgar Filing: OLD SECOND BANCORP INC - Form 10-Q

Liabilities:

| | | | | |
|---|------|-------|------|-------|
| Other liabilities (Interest rate swap agreements) | \$ - | \$ 42 | \$ - | \$ 42 |
| Total | \$ - | \$ 42 | \$ - | \$ 42 |

26

Table of Contents

| | December 31, 2013 | | | Total |
|---|-------------------|------------|------------|------------|
| | Level 1 | Level 2 | Level 3 | |
| Assets: | | | | |
| Investment securities available-for-sale | | | | |
| U.S. Treasury | \$ 1,544 | \$ - | \$ - | \$ 1,544 |
| U.S. government agencies | - | 1,672 | - | 1,672 |
| States and political subdivisions | - | 16,669 | 125 | 16,794 |
| Corporate bonds | - | 15,102 | - | 15,102 |
| Collateralized mortgage obligations | - | 63,876 | - | 63,876 |
| Asset-backed securities | - | 119,066 | 154,137 | 273,203 |
| Loans held-for-sale | - | 3,822 | - | 3,822 |
| Mortgage servicing rights | - | - | 5,807 | 5,807 |
| Other assets (Interest rate swap agreements net of swap credit valuation) | - | 229 | (6) | 223 |
| Other assets (Mortgage banking derivatives) | - | 315 | - | 315 |
| Total | \$ 1,544 | \$ 220,751 | \$ 160,063 | \$ 382,358 |
| Liabilities: | | | | |
| Other liabilities (Interest rate swap agreements) | \$ - | \$ 229 | \$ - | \$ 229 |
| Total | \$ - | \$ 229 | \$ - | \$ 229 |

The changes in Level 3 assets and liabilities measured at fair value on a recurring basis are as follows:

| | Nine months ended September 30, 2014 | | | |
|---|--------------------------------------|-----------------------------------|---------------------------|------------------------------|
| | Securities available-for-sale | | | |
| | Asset-backed | States and Political Subdivisions | Mortgage Servicing Rights | Interest Rate Swap Valuation |
| Beginning balance January 1, 2014 | \$ 154,137 | \$ 125 | \$ 5,807 | \$ (6) |
| Transfers into Level 3 | - | - | - | - |
| Total gains or losses | | | | |
| Included in earnings (or changes in net assets) | 3,178 | - | (761) | 6 |
| Included in other comprehensive income | (1,748) | - | - | - |
| Purchases, issuances, sales, and settlements | | | | |
| Purchases | 63,704 | - | - | - |
| Issuances | - | - | 594 | - |
| Sales | (135,490) | - | - | - |
| Ending balance September 30, 2014 | \$ 83,781 | \$ 125 | \$ 5,640 | \$ - |

| | Nine months ended September 30, 2013 | | | | |
|---|--------------------------------------|--------------|--------------|-----------|---------------|
| | Securities available-for- sale | | States and | Mortgage | Interest Rate |
| | Collateralized Debt | Asset-backed | Political | Servicing | Swap |
| | Obligations | | Subdivisions | Rights | Valuation |
| Beginning balance January 1, 2013 | \$ 9,957 | \$ - | \$ 132 | \$ 4,116 | \$ (47) |
| Transfers into Level 3 | - | - | - | - | - |
| Transfers out of Level 3 | - | - | - | - | - |
| Total gains or losses | | | | | |
| Included in earnings (or changes in net assets) | 178 | 485 | - | 81 | 34 |
| Included in other comprehensive income | 1,898 | (1,487) | - | - | - |
| Purchases, issuances, sales, and settlements | | | | | |
| Purchases | - | 168,753 | - | - | - |
| Issuances | - | - | - | 1,259 | - |
| Settlements | (946) | - | - | - | - |
| Sales | - | (20,539) | - | - | - |
| Ending balance September 30, 2013 | \$ 11,087 | \$ 147,212 | \$ 132 | \$ 5,456 | \$ (13) |

Table of Contents

The following table and commentary presents quantitative (dollars in thousands) and qualitative information about Level 3 fair value measurements as of September 30, 2014:

| Measured at fair value on a recurring basis: | Fair Value | Valuation Methodology | Unobservable Inputs | Range of Input | Weighted Average of Inputs |
|--|------------|---|---------------------|----------------|----------------------------|
| Mortgage Servicing rights | 5,640 | Discounted Cash Flow | Discount Rate | 10.0-30.75% | 10.3 % |
| | | | Prepayment Speed | 3.97-77.99% | 9.5 % |
| Asset-backed securities | 83,781 | Discounted Cash Flow with comparable transaction yields | Credit Risk Premium | 0.8-1.2% | 1.0 % |
| | | | Liquidity Discount | 4.0-4.3% | 4.2 % |

The following table and commentary presents quantitative (dollars in thousands) and qualitative information about Level 3 fair value measurements as of December 31, 2013:

| Measured at fair value on a recurring basis: | Fair Value | Valuation Methodology | Unobservable Inputs | Range of Input | Weighted Average of Inputs |
|--|------------|---|------------------------|----------------|----------------------------|
| Mortgage Servicing rights | 5,807 | Discounted Cash Flow | Discount Rate | 10.2% | 10.2 % |
| | | | Prepayment Speed | 9.7% | 9.7 % |
| Interest Rate Swap Valuation | (6) | Management estimate of credit risk exposure | Probability of Default | 5.0-20% | 12.5 % |
| Asset-backed securities | 154,137 | Discounted Cash Flow with comparable transaction yields | Credit Risk Premium | 1.1-1.5% | 1.2 % |
| | | | Liquidity Discount | 4.5-5.1% | 4.9 % |

The \$125,000 on the state and political subdivisions line at September 30, 2014 and December 31, 2013, under Level 3 represents a security from a small, local municipality. Given the small dollar amount and size of the municipality involved, this is categorized as Level 3 based on the payment stream received by the Company from the municipality. That payment stream is otherwise an unobservable input.

Assets and Liabilities Measured at Fair Value on a Nonrecurring Basis:

The Company may be required, from time to time, to measure certain other assets at fair value on a nonrecurring basis in accordance with GAAP. These assets consist of impaired loans and OREO. For assets measured at fair value on a nonrecurring basis at September 30, 2014, and December 31, 2013, respectively, the following tables provide the level of valuation assumptions used to determine each valuation and the carrying value of the related assets:

| | September 30, 2014 | | | Total |
|---|--------------------|---------|-----------|-----------|
| | Level 1 | Level 2 | Level 3 | |
| Impaired loans ¹ | \$ - | \$ - | \$ 957 | \$ 957 |
| Other real estate owned, net ² | - | - | 40,877 | 40,877 |
| Total | \$ - | \$ - | \$ 41,834 | \$ 41,834 |

1 Represents carrying value and related write-downs of loans for which adjustments are substantially based on the appraised value of collateral for collateral-dependent loans, had a carrying amount of \$1.5 million, with a valuation allowance of \$541,000, resulting in a decrease of specific allocations within the allowance for loan losses of \$1.9 million for the nine months ended months ending September 30, 2014.

2 OREO is measured at the lower of carrying or fair value less costs to sell, and had a net carrying amount of \$40.9 million, which is made up of the outstanding balance of \$61.7 million, net of a valuation allowance of \$19.0 million and participations of \$1.8 million, at September 30, 2014.

Table of Contents

| | December 31, 2013 | | | Total |
|---|-------------------|---------|-----------|-----------|
| | Level 1 | Level 2 | Level 3 | |
| Impaired loans ¹ | \$ - | \$ - | \$ 9,103 | \$ 9,103 |
| Other real estate owned, net ² | - | - | 41,537 | 41,537 |
| Total | \$ - | \$ - | \$ 50,640 | \$ 50,640 |

1 Represents carrying value and related write-downs of loans for which adjustments are substantially based on the appraised value of collateral for collateral-dependent loans, had a carrying amount of \$11.5 million, with a valuation allowance of \$2.4 million, resulting in a decrease of specific allocations within the provision for loan losses of \$3.9 million for the year ending December 31, 2013.

2 OREO is measured at the lower of carrying or fair value less costs to sell, and had a net carrying amount of \$41.5 million, which is made up of the outstanding balance of \$65.9 million, net of a valuation allowance of \$22.3 million and participations of \$2.1 million, at December 31, 2013.

The Company also has assets that under certain conditions are subject to measurement at fair value on a nonrecurring basis. These assets include OREO and impaired loans. The Company has estimated the fair values of these assets based primarily on Level 3 inputs. OREO and impaired loans are generally valued using the fair value of collateral provided by third party appraisals. These valuations include assumptions related to cash flow projections, discount rates, and recent comparable sales. The numerical range of unobservable inputs for these valuation assumptions are not meaningful.

Note 13 – Financial Instruments with Off-Balance Sheet Risk and Derivative Transactions

To meet the financing needs of its customers, the Bank, as a subsidiary of the Company, is a party to various financial instruments with off-balance-sheet risk in the normal course of business. These off-balance-sheet financial instruments include commitments to originate and sell loans as well as financial standby, performance standby and commercial letters of credit. The instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated balance sheet. The Bank's exposure to credit loss for loan commitments and letters of credit is represented by the dollar amount of those instruments. Management generally uses the same credit policies and collateral requirements in making commitments and conditional obligations as it does for on-balance-sheet instruments.

Interest Rate Swaps

The Bank also has interest rate derivative positions to assist with risk management that are not designated as hedging instruments. These derivative positions relate to transactions in which the Bank enters an interest rate swap with a client while at the same time entering into an offsetting interest rate swap with another financial institution. Due to financial covenant violations relating to nonperforming loans, the Bank had \$3.1 million in investment securities pledged to support interest rate swap activity with three correspondent financial institutions at September 30, 2014. The Bank had \$3.1 million in investment securities pledged to support interest rate swap activity with three correspondent financial institutions at December 31, 2013.

In connection with each transaction, the Bank agreed to pay interest to the client on a notional amount at a variable interest rate and receive interest from the client on the same notional amount at a fixed interest rate. At the same time, the Bank agreed to pay another financial institution the same fixed interest rate on the same notional amount and receive the same variable interest rate on the same notional amount. The transaction allows the client to convert a variable rate loan to a fixed rate loan and is part of the Company's interest rate risk management strategy. Because the Bank acts as an intermediary for the client, changes in the fair value of the underlying derivative contracts offset each other and do not generally affect the results of operations. Fair value measurements include an assessment of credit risk related to the client's ability to perform on their contract position, however, and valuation estimates related to that exposure are discussed in Note 12 above. At September 30, 2014, the notional amount of non-hedging interest rate swaps was \$19.0 million with a weighted average maturity of 2.6 years. At December 31, 2013, the notional amount of non-hedging interest rate swaps was \$51.9 million with a weighted average maturity of 1.5 years. The Bank offsets derivative assets and liabilities that are subject to a master netting arrangement.

The Bank also grants mortgage loan interest rate lock commitments to borrowers, subject to normal loan underwriting standards. The interest rate risk associated with these loan interest rate lock commitments is managed with contracts for future deliveries of loans as well as selling forward mortgage-backed securities contracts. Loan interest rate lock commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. Commitments to originate residential mortgage loans held-for-sale and forward commitments to sell residential mortgage loans or forward MBS contracts are considered derivative instruments and changes in the fair value are recorded to mortgage banking revenue. Fair values are estimated based on observable changes in mortgage interest rates including mortgage-backed securities prices from the date of the commitment.

Table of Contents

The following table presents derivatives not designated as hedging instruments as of September 30, 2014, and periodic changes in the values of the interest rate swaps are reported in other noninterest income. Periodic changes in the value of the forward contracts related to mortgage loan origination are reported in the net gain on sales of mortgage loans.

| | Notional or Contractual Amount | Asset Derivatives | | Liability Derivatives | |
|---|--------------------------------------|---------------------------|------------|---------------------------|------------|
| | | Balance Sheet Location | Fair Value | Balance Sheet Location | Fair Value |
| Interest rate swap contracts net of credit valuation | \$ 19,018 | Other Assets | \$ 42 | Other Liabilities | \$ 42 |
| Commitments ¹ | 215,264 | Other Assets | 266 | N/A | - |
| Forward contracts ² | 15,000 | N/A | - | Other Liabilities | - |
| Total | | | \$ 308 | | \$ 42 |

¹Includes unused loan commitments and interest rate lock commitments.

²Includes forward MBS contracts and forward loan contracts.

The following table presents derivatives not designated as hedging instruments as of December 31, 2013.

| | Notional or Contractual Amount | Asset Derivatives | | Liability Derivatives | |
|---|--------------------------------------|---------------------------|------------|---------------------------|------------|
| | | Balance Sheet Location | Fair Value | Balance Sheet Location | Fair Value |
| Interest rate swap contracts net of credit valuation | \$ 51,877 | Other Assets | \$ 223 | Other Liabilities | \$ 229 |
| Commitments ¹ | 206,965 | Other Assets | 315 | N/A | - |
| Forward contracts ² | 11,500 | N/A | - | Other Liabilities | - |
| Total | | | \$ 538 | | \$ 229 |

¹Includes unused loan commitments and interest rate lock commitments.

²Includes forward MBS contracts.

Edgar Filing: OLD SECOND BANCORP INC - Form 10-Q

The Bank also issues letters of credit, which are conditional commitments that guarantee the performance of a customer to a third party. The credit risk involved and collateral obtained in issuing letters of credit are essentially the same as that involved in extending loan commitments to our customers. In addition to customer related commitments, the Company is responsible for letters of credit commitments that relate to properties held in OREO. The following table represents the Company's contractual commitments due to letters of credit as of September 30, 2014, and December 31, 2013.

The following table is a summary of letter of credit commitments (in thousands):

| | September 30, 2014 | | | December 31, 2013 | | |
|-------------------------|--------------------|-----------|-----------|-------------------|----------|----------|
| | Fixed | Variable | Total | Fixed | Variable | Total |
| Letters of credit: | | | | | | |
| Borrower: | | | | | | |
| Financial standby | \$ 55 | \$ 4,432 | \$ 4,487 | \$ 10 | \$ 3,886 | \$ 3,896 |
| Commercial standby | - | 49 | 49 | - | 51 | 51 |
| Performance standby | 416 | 5,819 | 6,235 | 1,580 | 2,723 | 4,303 |
| | 471 | 10,300 | 10,771 | 1,590 | 6,660 | 8,250 |
| Nonborrower: | | | | | | |
| Performance standby | - | 622 | 622 | - | 867 | 867 |
| | - | 622 | 622 | - | 867 | 867 |
| Total letters of credit | \$ 471 | \$ 10,922 | \$ 11,393 | \$ 1,590 | \$ 7,527 | \$ 9,117 |

Table of Contents

Note 14 – Fair Values of Financial Instruments

The estimated fair values approximate carrying amount for all items except those described in the following table. Investment security fair values are based upon market prices or dealer quotes, and if no such information is available, on the rate and term of the security. The carrying value of FHLBC stock approximates fair value as the stock is nonmarketable and can only be sold to the FHLBC or another member institution at par. During the years ended December 31, 2013, and 2012, the Company participated in multiple redemptions with the FHLBC and, using the redemption values as the carrying value, FHLBC stock is carried at a Level 2 fair value since December 31, 2012. The Company had redemptions of \$1.2 million in the third quarter of 2014. These redemptions were the only redemptions processed by the Company in the first nine months of 2014. Fair values of loans were estimated for portfolios of loans with similar financial characteristics, such as type and fixed or variable interest rate terms. Cash flows were discounted using current rates at which similar loans would be made to borrowers with similar ratings and for similar maturities. The fair value of time deposits is estimated using discounted future cash flows at current rates offered for deposits of similar remaining maturities. The fair values of borrowings were estimated based on interest rates available to the Company for debt with similar terms and remaining maturities. The fair value of off balance sheet volume is not considered material.

The carrying amount and estimated fair values of financial instruments were as follows:

| | September 30, 2014 | | | | |
|--|--------------------|---------------|------------|-----------|-----------|
| | Carrying Amount | Fair Value | Level 1 | Level 2 | Level 3 |
| Financial assets: | | | | | |
| Cash and due from banks | \$ 33,260 | \$ 33,260 | \$ 33,260 | \$ - | \$ - |
| Interest bearing deposits with financial institutions | 10,797 | 10,797 | 10,797 | - | - |
| Securities available-for-sale | 362,243 | 362,243 | 1,532 | 276,805 | 83,906 |
| Securities held-to-maturity | 263,040 | 264,343 | - | 264,343 | - |
| FHLBC and Reserve Bank Stock | 9,058 | 9,058 | - | 9,058 | - |
| Bank-owned life insurance | 56,438 | 56,438 | - | 56,438 | - |
| Loans held for sale | 3,422 | 3,422 | - | 3,422 | - |
| Loans, net | 1,117,552 | 1,119,781 | - | - | 1,119,781 |
| Accrued interest receivable | 4,931 | 4,931 | - | 4,931 | - |
| Financial liabilities: | | | | | |
| Noninterest bearing deposits | \$ 380,687 | \$ 380,687 | \$ 380,687 | \$ - | \$ - |
| Interest bearing deposits | 1,276,068 | 1,275,036 | - | 1,275,036 | - |
| Securities sold under repurchase agreements | 29,438 | 29,438 | - | 29,438 | - |
| Other short-term borrowings | 40,000 | 40,000 | - | 40,000 | - |
| Junior subordinated debentures | 58,378 | 54,840 | 32,532 | 22,308 | - |

Edgar Filing: OLD SECOND BANCORP INC - Form 10-Q

| | | | | | |
|-----------------------------------|--------|--------|---|--------|---|
| Subordinated debenture | 45,000 | 38,691 | - | 38,691 | - |
| Note payable and other borrowings | 500 | 414 | - | 414 | - |
| Borrowing interest payable | 73 | 73 | - | 73 | - |
| Deposit interest payable | 518 | 518 | - | 518 | - |

31

Table of Contents

| | December 31, 2013 | | | | |
|---|-------------------|------------|------------|-----------|-----------|
| | Carrying | Fair | | | |
| | Amount | Value | Level 1 | Level 2 | Level 3 |
| Financial assets: | | | | | |
| Cash and due from banks | \$ 33,210 | \$ 33,210 | \$ 33,210 | \$ - | \$ - |
| Interest bearing deposits with financial institutions | 14,450 | 14,450 | 14,450 | - | - |
| Securities available-for-sale | 372,191 | 372,191 | 1,544 | 216,385 | 154,262 |
| Securities held-to-maturity | 256,571 | 254,328 | - | 254,328 | - |
| FHLBC and Reserve Bank Stock | 10,292 | 10,292 | - | 10,292 | - |
| Bank-owned life insurance | 55,410 | 55,410 | - | 55,410 | - |
| Loans held-for-sale | 3,822 | 3,822 | - | 3,822 | - |
| Loans, net | 1,073,975 | 1,072,837 | - | - | 1,072,837 |
| Accrued interest receivable | 4,248 | 4,248 | - | 4,248 | - |
| Financial liabilities: | | | | | |
| Noninterest bearing deposits | \$ 373,389 | \$ 373,389 | \$ 373,389 | \$ - | \$ - |
| Interest bearing deposits | 1,308,739 | 1,312,476 | - | 1,312,476 | - |
| Securities sold under repurchase agreements | 22,560 | 22,560 | - | 22,560 | - |
| Other short-term borrowings | 5,000 | 5,000 | - | 5,000 | - |
| Junior subordinated debentures | 58,378 | 67,053 | 39,777 | 27,276 | - |
| Subordinated debenture | 45,000 | 39,896 | - | 39,896 | - |
| Note payable and other borrowings | 500 | 423 | - | 423 | - |
| Borrowing interest payable | 17,037 | 17,037 | 10,122 | 6,915 | - |
| Deposit interest payable | 762 | 762 | - | 762 | - |

Note 15 – Series B Preferred Stock (“Series B Stock”)

The Series B Stock was issued as part of the Treasury’s Troubled Asset Relief Program and Capital Purchase Program (the “CPP”). The Series B Stock qualifies as Tier 1 capital and pays cumulative dividends on the liquidation preference amount on a quarterly basis at a rate of 5% per annum for the first five years, and 9% per annum thereafter effective in February 2014. Concurrent with issuing the Series B Stock, the Company issued to the Treasury a ten year warrant to purchase 815,339 shares of the Company’s common stock at an exercise price of \$13.43 per share.

Subsequent to the Company’s receipt of the \$73.0 million in proceeds from the Treasury in the first quarter of 2009, the Company allocated the proceeds between the Series B Stock and the warrant that was issued. The Company recorded the warrant as equity, and the allocation was based on their relative fair values in accordance with accounting

guidance. The fair value was determined for both the Series B Stock and the warrant as part of the allocation process in the amounts of \$68.2 million and \$4.8 million, respectively.

On August 31, 2010, the Company announced that it would begin deferring quarterly cash dividends on its outstanding Series B Stock. Further, as discussed in Note 8, the Company also elected to defer interest payments on certain of its subordinated debentures. However, under the terms of the Series B Stock, if the Company failed to pay dividends for an aggregate of six quarters on the Series B Stock, whether or not consecutive, the holders would have the right to appoint representatives to the Company's board of directors. As the Company elected to defer dividends for more than six quarters, a new director was appointed by the Treasury to join the board during the fourth quarter of 2012. The terms of the Series B Stock also prevent the Company from paying cash dividends or generally repurchasing its common stock while Series B Stock dividends are in arrears.

The Treasury sold all of the Series B Stock held to third parties, including certain of our directors, in auctions that were completed in the first quarter of 2013. The Treasury also sold the warrant to a third party at a subsequent auction. Upon completion by Treasury of the auction, the Company's board affirmed the director appointed by Treasury to ongoing board membership, and the Series B director was elected by the holders of the Series B Stock at the Company's 2013 annual meeting.

As a result of the completed 2013 auctions, the Company's Board elected to stop accruing the dividend on the Series B Stock in the first quarter of 2013. Previously, the Company had accrued the dividend on the Series B Stock quarterly throughout the deferral period. Given the discount reflected in the results of the auction, the board believed that the Company would likely be able to redeem the Series B Stock at a price less than the face amount of the Series B Stock plus accrued and unpaid dividends. While the Company did not fully accrue the dividend on the Series B Stock in the first quarter of 2013 and did not accrue for it in subsequent quarters, the Company continued to evaluate whether accruing dividends on the Series B Stock was appropriate. In the second quarter of 2014, the Company completed redemption of 25,669 shares of its Series B Stock at a price equal to 94.75% of liquidation value provided that the holders of shares entered into agreements to forebear payment of dividends due and to waive any rights to such dividends upon redemption. Following the redemption, the Company resumed accrual in the second quarter of 2014. The Company currently intends to declare and pay future dividends on these shares. On August 15, 2014 the Company paid \$1.1 million in dividends on the Series B Stock. Payments of \$24.3 million resulted in redemption of 25,669 shares of Series B Stock in the second quarter of 2014. At

Table of Contents

September 30, 2014, the Company carried \$47.3 million of Series B Stock in total stockholders' equity. At December 31, 2013, the Company carried \$72.9 million of Series B Stock in total stockholders' equity.

Note 16 – Income Taxes

Income tax expense (benefit) for year to date September 30, 2014 and September 30, 2013 was as follows:

| | September 30, 2014 | September 30, 2013 |
|-------------------------------|--------------------|--------------------|
| Current federal | \$ (62) | \$ 129 |
| Current state | (17) | 35 |
| Deferred federal | 3,017 | 2,935 |
| Deferred state | 1,046 | 1,049 |
| Change in valuation allowance | - | (74,145) |
| | \$ 3,984 | \$ (69,997) |

The following were the components of the deferred tax assets and liabilities as of September 30, 2014 and December 31, 2013:

| | September 30, 2014 | December 31, 2013 |
|--|--------------------|-------------------|
| Allowance for loan losses | \$ 10,648 | \$ 12,725 |
| Deferred compensation | 798 | 788 |
| Amortization of core deposit | 1,993 | 1,656 |
| Goodwill amortization/impairment | 14,042 | 15,252 |
| Stock option expense | 642 | 583 |
| OREO write downs | 8,901 | 10,041 |
| Federal net operating loss (“NOL”) carryforward | 27,882 | 28,023 |
| State net operating loss (“NOL”) carryforward | 11,768 | 11,847 |
| Deferred tax credit | 1,453 | 1,444 |
| Other assets | 983 | 1,166 |
| Total deferred tax assets | 79,110 | 83,525 |
| Accumulated depreciation on premises and equipment | (834) | (1,035) |
| Accretion on securities | (31) | (8) |
| Mortgage servicing rights | (2,491) | (2,571) |
| State tax benefits | (6,667) | (6,994) |
| Other liabilities | (411) | (178) |

Edgar Filing: OLD SECOND BANCORP INC - Form 10-Q

| | | |
|---|-----------|-----------|
| Total deferred tax liabilities | (10,434) | (10,786) |
| Net deferred tax asset before valuation allowance | 68,676 | 72,739 |
| Tax effect on net unrealized losses on securities | 5,062 | 4,927 |
| Valuation allowance | (2,363) | (2,363) |
| Net deferred tax asset | \$ 71,375 | \$ 75,303 |

At September 30, 2014, the Company had a \$79.7 million federal net operating loss carryforward of which, \$24.4 million expires in 2030, \$31.4 million expires in 2031, \$8.6 million expires in 2032, and \$15.3 million expires in 2033. The Company had a \$123.9 million state net operating loss carryforward of which, \$28.2 million expires in 2021, and \$95.7 million expires in 2025. In addition, the Company had a \$1.5 million alternative minimum tax credit subject to indefinite carryforward.

Table of Contents

The components of the provision for deferred income tax expense (benefit) were as follows:

| | September 30, 2014 | September 30, 2013 |
|--|--------------------|--------------------|
| Allowance for loan losses | \$ 2,077 | \$ 4,536 |
| Deferred Compensation | (10) | (40) |
| Amortization of core-deposit | (337) | (519) |
| Stock option expense | (59) | 177 |
| OREO write-downs | 1,140 | 5,560 |
| Federal net operating loss carryforward | 141 | (5,634) |
| State net operating loss carryforward | 79 | (1,248) |
| Deferred tax credit | (9) | - |
| Depreciation | (201) | (117) |
| Net premiums and discounts on securities | 23 | (109) |
| Mortgage servicing rights | (80) | 596 |
| Goodwill amortization/impairment | 1,210 | 1,151 |
| State tax benefits | (327) | (333) |
| Change in valuation allowance | - | (74,145) |
| Other, net | 416 | (36) |
| Total deferred tax expense | \$ 4,063 | \$ (70,161) |

Effective tax rates differ from federal statutory rates applied to financial statement income (loss) due to the following:

| | September 30, 2014 | September 30, 2013 |
|--|--------------------|--------------------|
| Tax at statutory federal income tax rate | \$ 3,896 | \$ 4,156 |
| Nontaxable interest income, net of disallowed interest deduction | (182) | (183) |
| BOLI income | (360) | (553) |
| State income taxes, net of federal benefit | 606 | 780 |
| Change in valuation allowance | - | (74,145) |
| Deficiency from restricted stock | - | 10 |
| Other, net | 24 | (62) |
| Tax at effective tax rate | \$ 3,984 | \$ (69,997) |

Table of Contents

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Overview

The Company is a financial services company with its main headquarters located in Aurora, Illinois. The Company is the holding company of Old Second National Bank (the "Bank"), a national banking organization headquartered in Aurora, Illinois that provides commercial and retail banking services, as well as a full complement of trust and wealth management services. The Company has offices located in Cook, Kane, Kendall, DeKalb, DuPage, LaSalle and Will counties in Illinois. The following management's discussion and analysis presents information concerning our financial condition as of September 30, 2014, as compared to December 31, 2013, and the results of operations for the three and nine months ended September 30, 2014 and 2013. This discussion and analysis is best read in conjunction with our consolidated financial statements as well as the financial and statistical data appearing elsewhere in this report and our 2013 Form 10-K.

In the markets where the Company operates, economies continued to gain momentum at a lackluster pace. Management believes the national economic statistics indicate an improving economy. However, economies in the Company's markets created only low levels of loan demand. Commercial Real Estate in our market areas remains stabilized with only vacant land in the far western portions of our operating area showing signs of stress. Residential mortgage demand was steady in the quarter but has yet to return to levels seen in 2013. Management continues to focus on growing commercial business. In the third quarter, existing commercial customers continued to see modest growth and profit margin improvement.

The Company remains vigilant in analyzing loan portfolio quality and making decisions to charge-off loans. Management review of the loan portfolio concluded that the reserve for loan and lease loss was adequate and appropriate for losses estimable at September 30, 2014. No loan loss reserve release or provision was recorded in the quarter. This compared to a \$1.8 million loan loss reserve release for the third quarter of 2013 and a \$1.0 million loan loss reserve release in each prior quarter of 2014.

Net income before taxes of \$4.7 million in the third quarter of 2014 compares to \$2.9 million for the third quarter of 2013 and \$3.1 million in the second quarter of 2014. Last year's quarter included lower levels of net interest income and gains on securities sales as well as higher levels of compensation and OREO noninterest expense. When compared to the third quarter, the second quarter 2014 reflected a lower level of gains on securities sales and net interest income as well as a \$1.0 million loan loss reserve release offset by higher noninterest expenses.

On September 17, 2014, the Company announced that James L. Eccher will be appointed the Chief Executive Officer and President of the Company, effective as of January 1, 2015, and that William B. Skoglund will retire from the position of Chief Executive Officer and President of the Company on the same date. Mr. Eccher will remain the Chief Executive Officer and President of the Bank. Following his retirement, Mr. Skoglund will remain the Chairman of the Board of both the Company and the Bank.

On September 16, 2014, the Company entered into an Employment Agreement (the "Agreement") with Mr. Eccher. Pursuant to the terms of the Agreement, Mr. Eccher will serve as Chief Executive Officer and President of the Company for a term of two (2) years beginning January 1, 2015, which term shall automatically extend for one

additional year beginning on January 1, 2016 and each January 1 thereafter. Mr. Eccher will remain eligible for all other benefits currently available to him, including a monthly car allowance, reimbursement of country club dues, the Company's incentive plans and medical, dental, disability, group and executive life insurance.

Results of Operations

In the third quarter of 2014, earnings per share were \$0.06 per diluted share on net income available to common shareholders of \$1.9 million. Earnings per share for the second quarter of 2014 were \$0.26 per diluted share on \$7.5 million of net income to common stockholders. Absent the benefits from gain on redemption of the Series B Stock and the Series B Stock dividends that were waived by the holders of Series B Stock that was redeemed, the Company realized \$0.02 per diluted share in the second quarter. These results compare to \$0.15 per diluted share, on net income to common stockholders of \$2.2 million for the second quarter of 2013 and net income available to common stockholders of \$630,000 for the first quarter of 2014. All 2014 Series B Stock dividends incorporate an increase in the dividend rate from 5% to 9% in February of 2014.

Table of Contents

Third quarter net income before taxes increased by \$1.7 million from the third quarter of 2013 and \$1.6 million from the second quarter of 2014. The increase from the third quarter of 2013 was driven by sharply higher gains on securities sales (a loss item in 2013), improved debit card interchange income reflecting an improving trend seen over recent quarters, and lower noninterest expense, notably Other Real Estate Owned (“OREO”) expenses were down because of lower valuation expenses. The linked quarter increase reflects improved net interest income, markedly higher gains on securities sales (up \$936,000) and reduced noninterest expense as the core deposit intangible asset reached full amortization and compensation costs moderated.

Third quarter net income available to common stockholders was \$1.9 million compared to \$1.6 million, after excluding the \$70.0 million tax benefit mainly from the reversal of a valuation allowance related to deferred tax assets, in the third quarter of 2013. On a linked quarter basis, third quarter net income available to common stockholders is compared to \$673,000 in the second quarter of this year, upon excluding the second quarter \$6.8 million benefit from the Company's redemption of a large amount of Series B Stock.

Net Interest Income

Net interest and dividend income increased \$1.0 million from \$13.7 million for the quarter ended June 30, 2014, to \$14.7 million for the quarter ended September 30, 2014. Average earning assets for the third quarter of 2014 decreased \$16.5 million, or 0.9%, from a total of \$1.81 billion in the second quarter of 2014. Loan production and participations or purchases in 2014 drove third quarter average loans, including loans held for sale, to a linked quarter nominal improvement of \$16.2 million, reversing the trend of declining average loan volume seen in 2013. Average loan volume for the third quarter, including loans held for sale, increased \$48.2 million when compared to the third quarter of 2013.

Repeating comments from previous reports, management continues to develop loan pipelines and expects that pipeline volume will generate future loan growth. As loan volume continues measured but slow paced growth, management decreased total securities in the third quarter of 2014 to 30.8% of total assets down from 31.4% at the end of 2013.

The net interest margin (tax-equivalent basis), expressed as a percentage of average earning assets, increased slightly from 3.25% in the third quarter of 2013 to 3.26% in the third quarter of 2014. The average tax-equivalent yield on earning assets decreased from 3.99% in the third quarter of 2013 to 3.78% in the third quarter of 2014. For the same comparative period, the cost of funds on interest bearing liabilities decreased from 0.94% to 0.70% providing some offset to the decrease in earning asset yield.

Period loan yields are reflective of competitive pressures on new loan yield. Additionally, management continued to see pressure to reduce interest rates on loans retained at renewal and found it necessary to accept rate concessions to retain business.

Management, in order to evaluate and measure performance, uses certain non-GAAP performance measures and ratios. This includes tax-equivalent net interest income (including its individual components) and net interest margin (including its individual components) to total average interest earning assets. Management believes that these measures and ratios provide users of the financial information with a more accurate view of the performance of the interest earning assets and interest bearing liabilities and of the Company's operating efficiency for comparison purposes. Other financial holding companies may define or calculate these measures and ratios differently. See the tables and notes below for supplemental data and the corresponding reconciliations to GAAP financial measures for the three and nine-month periods ended September 30, 2014, and 2013.

The following tables set forth certain information relating to the Company's average consolidated balance sheets and reflect the yield on average earning assets and cost of average liabilities for the periods indicated. Dividing the related interest by the average balance of assets or liabilities derives the disclosed rates. Average balances are derived from daily balances. For purposes of discussion, net interest income and net interest income to total earning assets on the following tables have been adjusted to a non-GAAP tax equivalent ("TE") basis using a marginal rate of 35% to more appropriately compare returns on tax-exempt loans and securities to other earning assets.

Table of Contents

ANALYSIS OF AVERAGE BALANCES,

TAX EQUIVALENT INTEREST AND RATES

Three Months Ended September 30, 2014 and 2013

(Dollar amounts in thousands - unaudited)

| | 2014 Average Balance | Interest | Rate | 2013 Average Balance | Interest | Rate |
|--|----------------------------|----------|--------|----------------------------|----------|--------|
| Assets | | | | | | |
| Interest bearing deposits | \$ 38,603 | \$ 25 | 0.25 % | \$ 36,456 | \$ 22 | 0.24 % |
| Securities: | | | | | | |
| Taxable | 600,386 | 3,586 | 2.39 | 605,546 | 3,113 | 2.06 |
| Non-taxable (TE) | 12,237 | 169 | 5.52 | 13,937 | 228 | 6.54 |
| Total securities | 612,623 | 3,755 | 2.45 | 619,483 | 3,341 | 2.16 |
| Dividends from Reserve Bank and FHLBC stock | 9,085 | 78 | 3.43 | 10,292 | 76 | 2.95 |
| Loans and loans held-for-sale (1) | 1,137,137 | 13,429 | 4.62 | 1,088,936 | 14,382 | 5.17 |
| Total interest earning assets | 1,797,448 | 17,287 | 3.78 | 1,755,167 | 17,821 | 3.99 |
| Cash and due from banks | 32,459 | - | - | 19,584 | - | - |
| Allowance for loan losses | (24,492) | - | - | (34,197) | - | - |
| Other noninterest bearing assets | 230,232 | - | - | 190,836 | - | - |
| Total assets | \$ 2,035,647 | | | \$ 1,931,390 | | |
| Liabilities and Stockholders' Equity | | | | | | |
| NOW accounts | \$ 321,968 | \$ 68 | 0.08 % | \$ 283,192 | \$ 63 | 0.09 % |
| Money market accounts | 299,846 | 70 | 0.09 | 311,213 | 104 | 0.13 |
| Savings accounts | 238,528 | 37 | 0.06 | 225,825 | 39 | 0.07 |
| Time deposits | 437,597 | 1,073 | 0.97 | 493,722 | 1,674 | 1.35 |
| Interest bearing deposits | 1,297,939 | 1,248 | 0.38 | 1,313,952 | 1,880 | 0.57 |
| Securities sold under repurchase agreements | 27,266 | 1 | 0.01 | 21,646 | 1 | 0.02 |
| Other short-term borrowings | 12,174 | 4 | 0.13 | 15,707 | 5 | 0.12 |
| Junior subordinated debentures | 58,378 | 1,072 | 7.35 | 58,378 | 1,336 | 9.15 |
| Subordinated debt | 45,000 | 199 | 1.73 | 45,000 | 209 | 1.82 |
| Notes payable and other borrowings | 500 | 4 | 3.13 | 500 | 4 | 3.13 |
| Total interest bearing liabilities | 1,441,257 | 2,528 | 0.70 | 1,455,183 | 3,435 | 0.94 |
| Noninterest bearing deposits | 389,246 | - | - | 366,889 | - | - |
| Other liabilities | 11,416 | - | - | 37,466 | - | - |
| Stockholders' equity | 193,728 | - | - | 71,852 | - | - |

Edgar Filing: OLD SECOND BANCORP INC - Form 10-Q

| | | | | |
|---|--------------|-----------|--------------|-----------|
| Total liabilities and stockholders' equity | \$ 2,035,647 | | \$ 1,931,390 | |
| Net interest income (TE) | | \$ 14,759 | | \$ 14,386 |
| Net interest income (TE) to total earning assets | | | 3.26 % | 3.25 % |
| Interest bearing liabilities to earning assets | 80.18 | % | 82.91 | % |

(1).Interest income from loans is shown on a TE basis as discussed below and includes fees of \$600,000 and \$793,000 for the third quarter of 2014 and 2013, respectively. Nonaccrual loans are included in the above-stated average balances.

37

Table of ContentsANALYSIS OF AVERAGE BALANCES,
TAX EQUIVALENT INTEREST AND RATES

Nine Months Ended September 30, 2014 and 2013

(Dollar amounts in thousands - unaudited)

| | 2014 Average Balance | Interest | Rate | 2013 Average Balance | Interest | Rate |
|--|----------------------------|----------|--------|----------------------------|----------|--------|
| Assets | | | | | | |
| Interest bearing deposits | \$ 30,958 | \$ 60 | 0.26 % | \$ 49,676 | \$ 91 | 0.24 % |
| Securities: | | | | | | |
| Taxable | 615,136 | 10,440 | 2.26 | 574,761 | 8,109 | 1.88 |
| Non-taxable (TE) | 18,114 | 579 | 4.26 | 14,912 | 679 | 6.07 |
| Total securities | 633,250 | 11,019 | 2.32 | 589,673 | 8,788 | 1.99 |
| Dividends from Reserve Bank and FHLBC stock | | | | | | |
| | 9,886 | 232 | 3.13 | 10,742 | 228 | 2.83 |
| Loans and loans held-for-sale (1) | 1,121,600 | 39,521 | 4.65 | 1,116,964 | 43,327 | 5.12 |
| Total interest earning assets | 1,795,694 | 50,832 | 3.74 | 1,767,055 | 52,434 | 3.92 |
| Cash and due from banks | 33,071 | - | - | 24,110 | - | - |
| Allowance for loan losses | (25,570) | - | - | (37,122) | - | - |
| Other noninterest bearing assets | 233,127 | - | - | 196,298 | - | - |
| Total assets | \$ 2,036,322 | | | \$ 1,950,341 | | |
| Liabilities and Stockholders' Equity | | | | | | |
| NOW accounts | \$ 311,701 | \$ 197 | 0.08 % | \$ 290,691 | \$ 192 | 0.09 % |
| Money market accounts | 308,109 | 247 | 0.11 | 319,876 | 342 | 0.14 |
| Savings accounts | 238,480 | 118 | 0.07 | 226,193 | 121 | 0.07 |
| Time deposits | 454,406 | 3,604 | 1.06 | 498,846 | 5,327 | 1.43 |
| Interest bearing deposits | 1,312,696 | 4,166 | 0.42 | 1,335,606 | 5,982 | 0.60 |
| Securities sold under repurchase agreements | | | | | | |
| | 25,687 | 2 | 0.01 | 22,206 | 2 | 0.01 |
| Other short-term borrowings | 8,352 | 8 | 0.13 | 20,000 | 24 | 0.16 |
| Junior subordinated debentures | 58,378 | 3,847 | 8.79 | 58,378 | 3,937 | 8.99 |
| Subordinated debt | 45,000 | 593 | 1.74 | 45,000 | 610 | 1.79 |
| Notes payable and other borrowings | 500 | 12 | 3.16 | 500 | 12 | 3.16 |
| Total interest bearing liabilities | 1,450,613 | 8,628 | 0.79 | 1,481,690 | 10,567 | 0.95 |
| Noninterest bearing deposits | 384,350 | - | - | 359,438 | - | - |
| Other liabilities | 22,927 | - | - | 35,432 | - | - |
| Stockholders' equity | 178,432 | - | - | 73,781 | - | - |
| Total liabilities and stockholders' equity | \$ 2,036,322 | | | \$ 1,950,341 | | |

Edgar Filing: OLD SECOND BANCORP INC - Form 10-Q

| | | | | |
|---|-------|-----------|--------|-----------|
| Net interest income (TE) | | \$ 42,204 | | \$ 41,867 |
| Net interest income (TE) to total earning assets | | | 3.14 % | 3.17 % |
| Interest bearing liabilities to earning assets | 80.78 | % | 83.85 | % |

1 Interest income from loans is shown on a TE basis as discussed below and includes fees of \$1.7 million and \$2.0 million for the first nine months of 2014 and 2013, respectively. Nonaccrual loans are included in the above stated average balances.

Table of Contents

As indicated previously, net interest income and net interest income to earning assets have been adjusted to a non-GAAP TE basis using a marginal rate of 35% to more appropriately compare returns on tax-exempt loans and securities to other earning assets. The table below provides a reconciliation of each non-GAAP TE measure to the GAAP equivalent for the periods indicated:

| (in thousands) | Three Months Ended | | Nine Months Ended | | | |
|---------------------------------|--------------------|--------------|-------------------|--------------|---|---|
| | September 30, | | September 30, | | | |
| | 2014 | 2013 | 2014 | 2013 | | |
| Net Interest Margin | | | | | | |
| Interest income (GAAP) | \$ 17,199 | \$ 17,724 | \$ 50,546 | \$ 52,146 | | |
| Taxable-equivalent adjustment: | | | | | | |
| Loans | 29 | 17 | 83 | 50 | | |
| Securities | 59 | 80 | 203 | 238 | | |
| Interest income - TE | 17,287 | 17,821 | 50,832 | 52,434 | | |
| Interest expense (GAAP) | 2,528 | 3,435 | 8,628 | 10,567 | | |
| Net interest income -TE | \$ 14,759 | \$ 14,386 | \$ 42,204 | \$ 41,867 | | |
| Net interest income (GAAP) | \$ 14,671 | \$ 14,289 | \$ 41,918 | \$ 41,579 | | |
| Average interest earning assets | \$ 1,797,448 | \$ 1,755,167 | \$ 1,795,694 | \$ 1,767,055 | | |
| Net interest margin (GAAP) | 3.24 | % 3.23 | % 3.12 | % 3.15 | % | % |
| Net interest margin - TE | 3.26 | % 3.25 | % 3.14 | % 3.17 | % | % |

Asset Quality

The Company had no loan loss reserve release or provision in the third quarter of 2014. By comparison, the Company recognized a \$1.8 million reserve release in the third quarter of 2013 and a \$1.0 million reserve release in the second quarter of 2014. The provision for loan loss creates a reserve for probable and estimable losses inherent in the loan portfolio. On a quarterly basis, management estimates the amount required and records the appropriate provision or release to maintain an adequate reserve for all potential and estimated loan losses.

Nonperforming loans increased to \$32.3 million at September 30, 2014 from \$28.9 million at June 30, 2014. The increase is driven by a small number of specific relationships and does not reflect issues throughout the portfolio. Net charge-offs totaled \$526,000 in the third quarter of 2014 while net charge-offs totaled \$3.7 million for the third quarter of 2013. The distribution of the Company's remaining nonperforming loans is included in the following table.

| (in thousands) | Nonperforming Loans as of | | | September 30, 2014 Dollar Change From | |
|---------------------------------|---------------------------|------------------|----------------------|--|----------------------|
| | September 30, 2014 | June 30, 2014 | December 31, 2013 | June 30, 2014 | December 31, 2013 |
| Real estate-construction | \$ 794 | \$ 807 | \$ 2,729 | \$ (13) | \$ (1,935) |
| Real estate-residential: | | | | | |
| Investor | 1,901 | 3,932 | 6,615 | (2,031) | (4,714) |
| Owner occupied | 7,312 | 5,535 | 6,190 | 1,777 | 1,122 |
| Revolving and junior liens | 2,340 | 2,199 | 3,209 | 141 | (869) |
| Real estate-commercial, nonfarm | 18,312 | 16,390 | 21,024 | 1,922 | (2,712) |
| Real estate-commercial, farm | - | - | - | - | - |
| Commercial | 1,645 | 56 | 27 | 1,589 | 1,618 |
| Other | - | - | - | - | - |
| | \$ 32,304 | \$ 28,919 | \$ 39,794 | \$ 3,385 | \$ (7,490) |

Nonperforming loans consist of nonaccrual loans, nonperforming restructured accruing loans and loans 90 days or greater past due. Remediation work continues in all segments. New migration to nonaccrual increased to \$11.7 million during the third quarter of 2014 compared to \$1.6 million in the second quarter of 2014 and \$1.5 million in the third quarter of 2013. For the first nine months of 2014 new migration to nonaccrual was \$18.2 million compared to \$17.4 million for the nine months ending 2013.

Table of Contents

| Loan Charge-offs, net of recoveries (in thousands) | Three Months Ended | | |
|---|-----------------------|------------------|----------------------|
| | September 30, 2014 | June 30, 2014 | December 31, 2013 |
| Real estate-construction | | | |
| Homebuilder | \$ - | \$ (130) | \$ - |
| Land | - | - | (1) |
| Commercial speculative | - | (226) | 62 |
| All other | (2) | (6) | 1 |
| Total real estate-construction | (2) | (362) | 62 |
| Real estate-residential | | | |
| Investor | 59 | (13) | 547 |
| Owner occupied | (108) | 96 | (15) |
| Revolving and junior liens | 328 | 206 | 139 |
| Total real estate-residential | 279 | 289 | 671 |
| Real estate-commercial, nonfarm | | | |
| Owner general purpose | 237 | 182 | - |
| Owner special purpose | 49 | 347 | (3) |
| Non-owner general purpose | (419) | 145 | (1,258) |
| Non-owner special purpose | 255 | - | - |
| Retail properties | (455) | (1) | 296 |
| Total real estate-commercial, nonfarm | (333) | 673 | (965) |
| Real estate-commercial, farm | | | |
| Commercial | 506 | (32) | (7) |
| Other | 76 | 52 | 5 |
| | \$ 526 | \$ 620 | \$ (234) |

Charge-offs for the third quarter of 2014 were, in many instances, from previously established specific reserves on nonaccrual loans deemed uncollectible. Gross charge-offs for the third quarter of 2014 were \$2.2 million compared to \$4.7 million for the third quarter of 2013 reflecting our efforts to improve loan quality in better but still challenging markets. Recoveries were \$1.6 million and \$950,000 for the same time periods, respectively.

Classified loans as of

September 30, 2014
Dollar Change From

Edgar Filing: OLD SECOND BANCORP INC - Form 10-Q

| (in thousands) | September 30, 2014 | September 30, 2014 | December 31, 2013 | June 30, 2014 | December 31, 2013 |
|---------------------------------|-----------------------|-----------------------|----------------------|------------------|----------------------|
| Real estate-construction | \$ 4,298 | \$ 4,330 | \$ 3,024 | \$ (32) | \$ 1,274 |
| Real estate-residential: | | | | | |
| Investor | 3,407 | 5,312 | 9,750 | (1,905) | (6,343) |
| Owner occupied | 7,797 | 5,841 | 7,699 | 1,956 | 98 |
| Revolving and junior liens | 3,675 | 3,097 | 3,971 | 578 | (296) |
| Real estate-commercial, nonfarm | 24,768 | 19,634 | 37,297 | 5,134 | (12,529) |
| Real estate-commercial, farm | - | - | - | - | - |
| Commercial | 4,251 | 312 | 481 | 3,939 | 3,770 |
| Other | 1 | 1 | 1 | - | - |
| | \$ 48,197 | \$ 38,527 | \$ 62,223 | \$ 9,670 | \$ (14,026) |

Classified loans include nonaccrual, performing troubled debt restructurings and all other loans considered substandard. Loans classified as substandard are inadequately protected by either the current net worth and paying capacity of the obligor, or by the collateral pledged to secure the loan, if any. These loans have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt and carry the distinct possibility that the Company will sustain some loss if deficiencies remain uncorrected. Management review of classified loans concluded that the September 30, 2014 total was driven by a small number of specific relationships and does not reflect issues throughout the portfolio.

Table of Contents

Classified assets include both classified loans and OREO. Management monitors a ratio of classified assets to the sum of Bank Tier 1 capital and the allowance for loan and lease loss reserve as another measure of overall change in loan related asset quality. With the growth in both classified loans and OREO in the third quarter of 2014, this ratio increased to 35.15% at September 30, 2014 from 31.27% at June 30, 2014 and down from 43.44% at December 31, 2013.

Allowance for Loan and Lease Losses

Below is a reconciliation of the activity for loan losses for the periods indicated (in thousands):

| | Three Months Ended | | | | | |
|--|-----------------------|------------------|----------------------|---|--------|---|
| | September 30, 2014 | June 30, 2014 | December 31, 2013 | | | |
| Allowance at beginning of quarter | \$ 23,856 | \$ 25,476 | \$ 29,547 | | | |
| Charge-offs: | | | | | | |
| Commercial | 512 | 3 | 8 | | | |
| Real estate - commercial | 545 | 760 | 608 | | | |
| Real estate - construction | 1 | 105 | 63 | | | |
| Real estate - residential | 925 | 978 | 1,100 | | | |
| Consumer and other loans | 174 | 139 | 123 | | | |
| Total charge-offs | 2,157 | 1,985 | 1,902 | | | |
| Recoveries: | | | | | | |
| Commercial | 6 | 35 | 15 | | | |
| Real estate - commercial | 878 | 87 | 1,573 | | | |
| Real estate - construction | 3 | 467 | 1 | | | |
| Real estate - residential | 646 | 689 | 429 | | | |
| Consumer and other loans | 98 | 87 | 118 | | | |
| Total recoveries | 1,631 | 1,365 | 2,136 | | | |
| Net charge-offs (recoveries) | 526 | 620 | (234) | | | |
| Loan loss reserve release | - | (1,000) | (2,500) | | | |
| Allowance at end of period | \$ 23,330 | \$ 23,856 | \$ 27,281 | | | |
| Average total loans (exclusive of loans held-for-sale) | 1,133,379 | 1,118,089 | 1,072,320 | | | |
| Net charge-offs to average loans | 0.05 | % | 0.06 | % | (0.02) | % |
| Allowance at period end to average loans | 2.06 | % | 2.13 | % | 2.54 | % |
| Ending balance: Individually evaluated for impairment | \$ 541 | \$ 1,440 | \$ 2,395 | | | |
| Ending balance: Collectively evaluated for impairment | \$ 22,789 | \$ 22,416 | \$ 24,886 | | | |

The coverage ratio of the allowance for loan losses to nonperforming loans was 72.2% at September 30, 2014 down from 82.5% as of June 30, 2014 and improved from 68.6% as of December 31, 2013. Management updated the estimated specific allocations in the third quarter after receiving more recent appraisals of collateral or information on cash flow trends related to the impaired credits. This update resulted in a sharply lower amount required in the reserve for estimable losses on these credits at the end of the third quarter 2014 compared to year end 2013 as well as second quarter 2014. The estimated general risk allocation was also lower when compared to both June 30, 2014 and December 31, 2013. The third component of the Company's loan loss reserve analysis showed higher required reserves when compared to June 30, 2014, most notably in the pooled commercial real estate category. Management determined that the dollar amount of loans in this component was \$7.1 million or markedly higher at period end third quarter 2014 compared to \$3.2 million at June 30, 2014. The dollar amount in the pooled commercial real estate category at September 30, 2014 was sharply improved from year end 2013.

After a review of the adequacy of the loan loss reserve at September 30, 2014, management concluded that, for the third quarter of 2014 neither a loan loss provision or a loan loss reserve release were appropriate. When measured as a percentage of loans outstanding, the total allowance for loan losses decreased slightly from 2.5% of total loans as of December 31, 2013 to 2.1% of total loans at September 30, 2014. In management's judgment, an adequate allowance for estimated losses has been established for inherent losses at September 30, 2014; however, there can be no assurance that actual losses will not exceed the estimated amounts in the future.

Table of Contents

Other Real Estate Owned

OREO increased modestly to \$40.9 million at September 30, 2014, from \$39.2 million at June 30, 2014 and decreased modestly from \$41.5 million at December 31, 2013. Property additions and improvements exceeded property disposals and valuation adjustments to OREO in the three months ended September 30, 2014. Third quarter additions to OREO included the reclassification of the New Lenox branch property, which reflected management's third quarter decision to close the branch on October 24, 2014. The nine months ended September 30, 2014 saw property disposals and valuation adjustments, exceed property additions and improvements to OREO by a nominal amount. The quarterly property additions and improvements have been relatively consistent at \$4.7 million, \$4.8 million and \$4.8 million for the quarters ended March 31, 2014, June 30, 2014 and September 30, 2014, respectively. At the same time, property disposals slowed and valuation adjustments spiked for a combined reduction to OREO of \$3.1 million for the quarter ended September 30, 2014, compared to combined reductions of \$6.0 million and \$5.8 million for the quarters ended March 31, 2014 and June 30, 2014, respectively. All OREO improvements in 2014 relate to several multifamily properties that were otherwise in severe disrepair.

| (in thousands) | Three Months Ended | | |
|------------------------------|-----------------------|------------------|----------------------|
| | September 30, 2014 | June 30, 2014 | December 31, 2013 |
| Beginning balance | \$ 39,232 | \$ 40,220 | \$ 49,066 |
| Property additions | 4,277 | 4,655 | 4,998 |
| Property improvements | 506 | 131 | 13 |
| Less: | | | |
| Property disposals | 1,618 | 4,949 | 10,784 |
| Period valuation adjustments | 1,520 | 825 | 1,756 |
| Other real estate owned | \$ 40,877 | \$ 39,232 | \$ 41,537 |

The OREO valuation reserve was \$19.0 million, which was 31.8% of gross OREO at September 30, 2014. The valuation reserve represented 33.4% and 34.9% of gross OREO at September 30, 2013, and December 31, 2013, respectively. In management's judgment, the property valuation allowance as established presents OREO at current estimates of fair value less estimated costs to sell; however, there can be no assurance that additional losses will not be incurred on disposal or upon update to valuation in the future. Of note, one commercial property of five lots valued in total at \$1.0 million has been in OREO for over five years.

OREO Properties by Type

| (in thousands) | September 30, 2014 | | June 30, 2014 | | December 31, 2013 | |
|-------------------------------------|--------------------|------------|---------------|------------|-------------------|------------|
| | Amount | % of Total | Amount | % of Total | Amount | % of Total |
| Single family residence | \$ 3,424 | 9 % | \$ 3,485 | 9 % | \$ 4,658 | 11 % |
| Lots (single family and commercial) | 14,258 | 35 % | 15,002 | 38 % | 15,020 | 36 % |
| Vacant land | 2,595 | 6 % | 2,595 | 7 % | 3,135 | 8 % |
| Multi-family | 6,140 | 15 % | 5,175 | 13 % | 1,783 | 4 % |
| Commercial property | 14,460 | 35 % | 12,975 | 33 % | 16,941 | 41 % |
| Total OREO properties | \$ 40,877 | 100 % | \$ 39,232 | 100 % | \$ 41,537 | 100 % |

Table of Contents

Noninterest Income

| (in thousands) | Three Months Ended | | | 3rd Qtr 2014 Dollar Change From | |
|---|--------------------|----------|----------|---------------------------------------|---------|
| | 3rd Qtr | 2nd Qtr | 3rd Qtr | 2nd Qtr | 3rd Qtr |
| | 2014 | 2014 | 2013 | 2014 | 2013 |
| Trust income | \$ 1,483 | \$ 1,677 | \$ 1,494 | \$ (194) | \$ (11) |
| Service charges on deposits | 1,838 | 1,796 | 1,904 | 42 | (66) |
| Residential mortgage banking revenue | 1,340 | 1,257 | 1,232 | 83 | 108 |
| Securities (loss) gains, net | 1,231 | 295 | (7) | 936 | 1,238 |
| Increase in cash surrender value of bank-owned life insurance | 304 | 366 | 419 | (62) | (115) |
| Death benefit realized on bank-owned life insurance | - | - | 6 | - | (6) |
| Debit card interchange income | 1,011 | 930 | 873 | 81 | 138 |
| Other income | 1,116 | 1,160 | 1,549 | (44) | (433) |
| Total noninterest income | \$ 8,323 | \$ 7,481 | \$ 7,470 | \$ 842 | \$ 853 |

On a linked quarter as well as year over year basis, gains from securities sales drove improved noninterest income. Debit card interchange income also strengthened while residential mortgage banking revenue improved in a difficult market. On a year to date basis, residential mortgage banking revenue declined approximately 48.9%. Trust income declined from second quarter's level reflecting stronger than normal estate administration fees in second quarter that returned to normal quarterly results. Second quarter trust income also included nonrecurring tax preparation fees. Year to date noninterest income is down 19.0% from 2013 essentially across all categories with the large dollar and percentage declines found in residential mortgage banking revenue and securities gains.

Noninterest Expense

3rd Qtr 2014

Three Months Ended

Edgar Filing: OLD SECOND BANCORP INC - Form 10-Q

| (in thousands) | 3rd Qtr 2014 | 2nd Qtr 2014 | 3rd Qtr 2013 | Dollar Change From | |
|---|-----------------|-----------------|-----------------|-----------------------|-----------------|
| | | | | 2nd Qtr 2014 | 3rd Qtr 2013 |
| Salaries | \$ 7,141 | \$ 7,128 | \$ 7,010 | \$ 13 | \$ 131 |
| Bonus | 475 | 592 | 903 | (117) | (428) |
| Benefits and other | 1,240 | 1,463 | 1,386 | (223) | (146) |
| Total salaries and employee benefits | 8,856 | 9,183 | 9,299 | (327) | (443) |
| Occupancy expense, net | 1,143 | 1,185 | 1,266 | (42) | (123) |
| Furniture and equipment expense | 989 | 984 | 1,026 | 5 | (37) |
| FDIC insurance | 649 | 627 | 987 | 22 | (338) |
| General bank insurance | 371 | 343 | 489 | 28 | (118) |
| Amortization of core deposit intangible asset | 154 | 511 | 524 | (357) | (370) |
| Advertising expense | 291 | 459 | 347 | (168) | (56) |
| Debit card interchange expense | 418 | 412 | 366 | 6 | 52 |
| Legal fees | 332 | 409 | 615 | (77) | (283) |
| Other real estate owned expense, net | 2,007 | 1,650 | 2,544 | 357 | (537) |
| Other expense | 3,134 | 3,289 | 3,119 | (155) | 15 |
| Total noninterest expense | \$ 18,344 | \$ 19,052 | \$ 20,582 | \$ (708) | \$ (2,238) |

Noninterest expense decreased on a linked quarter basis primarily on reduced compensation costs, cessation of the core deposit amortization expense and reduced advertising with an offset in increased OREO expenses, net. The OREO expense increase included valuation expense greater than the improvements in net gains on OREO sales and other OREO expense reduction combined. Reduced compensation costs reflect lower bonus accrual and health care costs quarter to quarter. The core deposit intangible asset was fully amortized in July of 2014. Lower advertising expense resulted from reduced expense for online and print advertising of retail

Table of Contents

products. Expenses decreased in the third quarter of 2014 compared to the same period in 2013 in most categories, including total OREO expense, net. On a year to date basis, noninterest expense is down 12.9% from 2013. All expense information incorporates a year end 2013 Company decision to reclassify OREO revenues from noninterest income to noninterest expense.

Income Taxes

The Company recorded a tax expense of \$1.7 million on \$4.7 million pre-tax income for the third quarter of 2014. For the nine months ended September 30, 2014, tax expense was composed of \$79,000 in current income tax benefit and \$4.1 million in deferred income tax expense.

There have been no significant changes in the Company's ability to utilize the deferred tax assets through September 30, 2014. As such, the Company has not changed the valuation reserve on the deferred tax assets in 2014.

On September 12, 2012, the Company and the Bank, as rights agent, entered into the Amended and Restated Rights Agreement and Tax Benefits Preservation Plan (the "Tax Benefits Plan"). The Tax Benefits Plan amended and restated the Rights Agreement, dated September 17, 2002. The purpose of the Tax Benefits Plan is to protect the Company's deferred tax asset against an unsolicited ownership change, which could significantly limit the Company's ability to utilize its deferred tax assets. The Tax Benefits Plan was ratified by the Company's stockholders at the Company's 2013 annual meeting. In connection with the public offering, that closed in the second quarter of 2014, the Company amended the Tax Benefits Plan on April 3, 2014, to allow two identified investors who were purchasers in the offering to purchase more than 5% of the Company's common stock.

Financial Condition

Total assets increased \$29.1 million, or 1.5%, from December 31, 2013, to \$2.03 billion as of September 30, 2014. Loans increased by \$39.6 million, or 3.6%, as management continued to emphasize credit quality under an overarching relationship lending program. At the same time, loan charge-off activity reduced balances, and collateral that previously secured loans moved to OREO. OREO decreased \$660,000, or 1.6% at September 30, 2014, compared to year end 2013. Available-for-sale securities decreased by \$9.9 million while held-to-maturity securities increased \$6.5 million in the nine months ended September 30, 2014.

The core deposit intangible asset related to the Heritage Bank acquisition in February 2008 was fully amortized as of September 30, 2014 with incurred expense of \$1.2 million for the nine months ended September 30, 2014. Management performed an annual review of the core deposit intangible assets as of November 30, 2013.

Table of Contents

Loans

Total loans were \$1.14 billion as of September 30, 2014, an increase of \$39.6 million from \$1.10 billion as of December 31, 2013. The increase in loans reflects successful loan production work in the period after extensive work in previous periods to build a robust loan pipeline. In the first nine months of 2014, the Company was successful in adding commercial loans and continued to add real estate loans in commercial construction and real estate while experiencing reductions in residential real estate loan holdings. A noteworthy specific increase in the third quarter came from two large loans financing commercial real estate construction. Management views these financings as extensions of credit to highly rated clients with the properties to be constructed reflecting strong and well structured lease documents with excellent tenants. An overriding effort to develop relationship based loan clients also resulted in current loan clients more closely reflecting our core clientele. Our existing commercial clients continue to be reluctant in utilizing existing lines of credit. Challenging economic circumstances and an intensely competitive environment served to temper overall loan growth.

| (in thousands) | Major Classification of Loans as of | | | September 30, 2014 Dollar Change From | |
|-----------------------------|-------------------------------------|------------------|----------------------|--|----------------------|
| | September 30, 2014 | June 30, 2014 | December 31, 2013 | June 30, 2014 | December 31, 2013 |
| Commercial | \$ 106,592 | \$ 106,752 | \$ 94,736 | \$ (160) | \$ 11,856 |
| Real estate - commercial | 600,649 | 599,796 | 560,233 | 853 | 40,416 |
| Real estate - construction | 41,936 | 32,265 | 29,351 | 9,671 | 12,585 |
| Real estate - residential | 365,602 | 368,592 | 390,201 | (2,990) | (24,599) |
| Consumer | 3,142 | 3,064 | 2,760 | 78 | 382 |
| Overdraft | 1,198 | 381 | 628 | 817 | 570 |
| Lease financing receivables | 8,398 | 8,722 | 10,069 | (324) | (1,671) |
| Other | 12,757 | 12,700 | 12,793 | 57 | (36) |
| | 1,140,274 | 1,132,272 | 1,100,771 | 8,002 | 39,503 |
| Net deferred loan costs | 608 | 475 | 485 | 133 | 123 |
| | \$ 1,140,882 | \$ 1,132,747 | \$ 1,101,256 | \$ 8,135 | \$ 39,626 |

The quality of the loan portfolio incorporates not only Company credit decisions but also the economic health of the communities in which the Company operates. The local economies are still subject to the economic headwinds that have been experienced nationwide. The uneven and occasionally adverse economic conditions continue to affect the Midwest region in particular and financial markets generally. As the Company is located in a corridor with significant open space and undeveloped real estate, real estate lending (including commercial, residential, and construction) has been and continues to be a sizeable portion of the portfolio. These categories comprised 88.4% of the portfolio as of September 30, 2014, compared to 89.0% of the portfolio as of December 31, 2013. The Company continues to oversee and manage its loan portfolio in accordance with interagency guidance on risk management.

Table of Contents

Securities

| (in thousands) | Securities Portfolio As of | | | September 30, 2014 Dollar Change From | |
|--|----------------------------|------------------|----------------------|--|----------------------|
| | September 30, 2014 | June 30, 2014 | December 31, 2013 | June 30, 2014 | December 31, 2013 |
| Securities available-for-sale, at fair value | | | | | |
| U.S. Treasury | \$ 1,532 | \$ 1,538 | \$ 1,544 | \$ (6) | \$ (12) |
| U.S. government agencies | 1,638 | 1,653 | 1,672 | (15) | (34) |
| States and political subdivisions | 13,879 | 15,753 | 16,794 | (1,874) | (2,915) |
| Corporate bonds | 30,781 | 31,350 | 15,102 | (569) | 15,679 |
| Collateralized mortgage obligations | 28,417 | 33,083 | 63,876 | (4,666) | (35,459) |
| Asset-backed securities | 192,798 | 246,437 | 273,203 | (53,639) | (80,405) |
| Collateralized loan obligations | 93,198 | - | - | 93,198 | 93,198 |
| Total securities available-for-sale | \$ 362,243 | \$ 329,814 | \$ 372,191 | \$ 32,429 | \$ (9,948) |
| Securities held-to-maturity, at amortized cost | | | | | |
| U.S. government agency mortgage-backed | \$ 37,321 | \$ 37,306 | \$ 35,268 | \$ 15 | \$ 2,053 |
| Collateralized mortgage obligations | 225,719 | 227,377 | 221,303 | (1,658) | 4,416 |
| Total securities held-to-maturity | \$ 263,040 | \$ 264,683 | \$ 256,571 | \$ (1,643) | \$ 6,469 |
| Total securities | \$ 625,283 | \$ 594,497 | \$ 628,762 | \$ 30,786 | \$ (3,479) |

The total investment portfolio reached \$625.3 million at September 30, 2014. The Available-for-Sale (“AFS”) portfolio increased \$32.4 million during the third quarter to end at \$362.2 million. Collateralized loan obligations (“CLO”) totaling \$94.2 million were purchased early in the quarter. Asset-backed security (“ABS”) sales for the quarter were \$95.3 million, partially offset by purchases of \$42.4 million. Sales of ABS, some late in the second quarter, provided funding for the CLO purchases. The Company had no purchase or sale activity in the Held to Maturity portfolio in the third quarter.

Realized gains totaled \$1.2 million for the third quarter of 2014. Unrealized losses on the AFS portfolio before deferred taxes were \$5.2 million at September 30, 2014 an increase of \$3.5 million for the quarter.

The Company is holding investments by four issuers where each issuer holding exceeds 10% of stockholders’ equity. Company investment managers have assessed the quality of the issuers to confirm that underwriting standards meet expectation and requirements under the Investment Policy. All of the investments for these issuers are guaranteed by the U.S. Department of Education.

The Company’s Board of Directors, at their July 15, 2014, meeting approved changes to the Investment Policy to allow purchases of CLO for the investment portfolio. Policy guidelines dictate that securities purchased are Volcker Rule compliant, are rated “A-“ or higher, and meet other stringent credit assessments. Policy also limits aggregate holdings and maximum issuer amount as percentages of capital.

As shown above, the addition of CLO to the portfolio and related reductions in other portfolio holdings, were the major events in the Company's securities asset management both in the third quarter 2014 and the nine month period ended September 30, 2014. At September 30, 2014, the Company investment managers have assessed the quality of the issuers to confirm that underwriting standards meet expectation and the requirements under the Company's Investment Policy.

While the Company's total securities holdings were essentially unchanged in the first nine months of 2014, meaningful changes were made in the period as discussed above to reduce available-for-sale ABS supported by student loan assets largely guaranteed by the U.S. Department of Education while increasing CLO holdings. The Company added a minor holding in held-to-maturity securities.

Table of Contents

Deposits and Borrowings

| (in thousands) | Deposit Detail As of | | | September 30, 2014 Dollar Change From | |
|---------------------------|-----------------------|------------------|----------------------|--|----------------------|
| | September 30, 2014 | June 30, 2014 | December 31, 2013 | June 30, 2014 | December 31, 2013 |
| Noninterest bearing | \$ 380,687 | \$ 393,964 | \$ 373,389 | \$ (13,277) | \$ 7,298 |
| Savings | 236,289 | 238,167 | 228,589 | (1,878) | 7,700 |
| NOW accounts | 315,665 | 310,721 | 297,852 | 4,944 | 17,813 |
| Money market accounts | 296,418 | 304,766 | 309,859 | (8,348) | (13,441) |
| Certificates of deposits: | | | | | |
| of less than \$100,000 | 256,452 | 274,971 | 288,345 | (18,519) | (31,893) |
| of \$100,000 or more | 171,244 | 178,235 | 184,094 | (6,991) | (12,850) |
| | \$ 1,656,755 | \$ 1,700,824 | \$ 1,682,128 | \$ (44,069) | \$ (25,373) |

Total deposits decreased \$25.4 million, or 1.5%, during the nine month period ended September 30, 2014 to \$1.66 billion. During the same period, savings, NOW and money market deposit volume increased by \$12.1 million. Also during the period, certificates of deposit decreased by \$44.7 million while noninterest bearing demand increased \$7.3 million. As of June 30, 2014, we continue to be among market share leaders in our home counties of Kane and Kendall in Illinois..

Average balance for interest bearing deposits was \$1.31 billion for the first nine months of 2014. Average balance for noninterest bearing deposits was \$384.4 million in the same period. Similar to the trends discussed above, when compared to the first nine months of 2013, average balances in 2014 reflect lower interest bearing deposit volumes, driven by time deposits, but increased noninterest bearing deposits. Management believes that reductions in average time deposits reflect maturities of deposits from past higher rate environments.

One of the Company's most significant borrowing relationships continued to be the \$45.5 million credit facility with a correspondent bank. That credit began in January 2008 and was originally composed of a \$30.5 million senior debt facility, which included \$500,000 in term debt, and \$45.0 million of subordinated debt. The subordinated debt and the term debt portion of the senior debt facility mature on March 31, 2018. The interest rate on the senior debt facility resets quarterly and at the Company's option, is based on, either the lender's prime rate or three-month LIBOR plus 90 basis points. The interest rate on the subordinated debt resets quarterly, and is equal to three-month LIBOR plus 150 basis points. The Company had no principal outstanding balance on the senior line of credit portion of the senior debt facility when it matured and was terminated. The Company had \$500,000 in principal outstanding in term debt and \$45.0 million in principal outstanding in subordinated debt at the end of both September 30, 2014, and December 31, 2013. The term debt is secured by all of the outstanding capital stock of the Bank. The Company has made all required interest payments on the outstanding principal amounts on a timely basis.

The credit facility agreement contains usual and customary provisions regarding acceleration of the senior debt upon the occurrence of an event of default by the Company under the senior debt agreement. The senior debt agreement also contains certain customary representations and warranties, and financial covenants. At September 30, 2014, the Company was out of compliance with two of the financial covenants contained within the credit agreement. As of June 30, 2014, the Company reported being out of compliance on one of the financial covenants contained in the referenced credit agreement. Prior to 2013, the Company had been out of compliance with two of the financial covenants. The agreement provides that noncompliance is an event of default and as the result of the Company's failure to comply with a financial covenant, the lender may (i) terminate all commitments to extend further credit, (ii) increase the interest rate on the revolving line of the term debt by 200 basis points, (iii) declare the senior debt immediately due and payable and (iv) exercise all of its rights and remedies at law, in equity and/or pursuant to any or all collateral documents, including foreclosing on the collateral. The total outstanding principal of the senior debt is the \$500,000 in term debt. Because the subordinated debt is treated as Tier 2 capital for regulatory capital purposes, the senior debt agreement does not provide the lender with any rights of acceleration or other remedies with regard to the subordinated debt upon an event of default caused by the Company's failure to comply with a financial covenant. Specifically, the covenants that were not met address the Bank's return on average assets and nonperforming assets as a percentage of the Bank's primary capital, when calculated per the debt agreement.

The Company increased its securities sold under repurchase agreements to \$29.4 million at September 30, 2014, from \$22.6 million at December 31, 2013. The Company had taken an advance of \$40.0 million at September 30, 2014 representing an increase when compared to \$5.0 million at December 31, 2013 and no outstanding advances at June 30, 2014.

The Company is also obligated on \$58.4 million of junior subordinated debentures related to the trust preferred securities issued by its two statutory trust subsidiaries, Old Second Capital Trust I and Old Second Capital Trust II. In April 2014, the Company concluded a successful capital raise and used some of the capital raise proceeds to pay interest accrued but previously unpaid on the trust preferred securities. The Company is currently paying interest as it comes due, and \$1.1 million was paid in the third quarter of 2014. The Company is current on all payments due on these securities.

Table of Contents

Capital

As of September 30, 2014, total stockholders' equity was \$192.7 million, which was an increase of \$45.0 million from \$147.7 million as of December 31, 2013. This increase was primarily attributable to the capital raise conducted in the second quarter of 2014 in which the Company issued 15,525,000 shares of common stock with net proceeds exceeding \$64.0 million. Subsequent to the offering, the Company used \$19.7 million to pay all outstanding interest on the junior subordinated debentures and repurchase 25,669 shares of Series B Stock. The Company repurchased the preferred shares for 94.75% of the liquidation value totaling payments of \$24.3 million. Payments of \$22.9 million were made to a large private investor with other payments totaling \$1.4 million made to directors of the Company. Lastly, the Company used \$10.3 million to pay all accumulated and outstanding Series B Stock dividends. As part of the Series B Stock repurchase agreements, the holders of the Series B Stock agreed to forbear any rights to accumulated, unpaid dividends. The remaining proceeds from the capital raise are being held for general corporate purposes.

The Bank is subject to the risk-based capital regulatory guidelines, which include the methodology for calculating the risk-weighting of the Bank's assets, developed by the OCC and the other bank regulatory agencies. In connection with the current economic environment, the Bank's current level of nonperforming assets and the risk-based capital guidelines, the Bank's board of directors has determined that the Bank should maintain a Tier 1 leverage capital ratio at or above eight percent (8%) and a total risk-based capital ratio at or above twelve percent (12%). The Bank currently exceeds those thresholds. See Note 11 -Regulatory and Capital Matters for a complete discussion of all regulatory capital guidelines.

As previously announced in the third quarter of 2010, the Company elected to defer regularly scheduled interest payments on \$58.4 million of junior subordinated debentures related to the trust preferred securities issued by its two statutory trust subsidiaries, Old Second Capital Trust I and Old Second Capital Trust II. Because of the deferral on the subordinated debentures, the trusts deferred regularly scheduled dividends on their trust preferred securities. On April 21, 2014, the Company paid the accumulated and unpaid interest on the trust preferred securities and terminated the deferral period. The interest was not immediately paid by the indenture trustees to the holders of such trust preferred securities. Instead, the trustees held the interest payments in irrevocable deposit accounts to pay such amounts on the next applicable payment dates under the indentures to holders of the securities on the record dates set forth in the appropriate indenture. In the third quarter of 2014, the Company paid \$1.1 million for the regularly scheduled payments.

During the fourth quarter 2012, the Treasury announced the continuation of individual auctions of the Series B Stock that was issued through the CPP. At that time, the Company was informed that the Series B Stock would be auctioned. Auction transactions were settled in first quarter 2013 reflecting Treasury's efforts to conclude the CPP. The auctions were successful for the Treasury as all of the Series B Stock held by Treasury was sold to third parties, including certain of our directors. At December 31, 2013 and September 30, 2014, the Company carried \$72.9 million and \$47.3 million, respectively of Series B Stock in total stockholders' equity. Pursuant to the terms of the Series B Stock, the dividends paid on the Series B Stock increased from 5% to 9% in February 2014. The Company paid \$1.1 million on August 15, 2014 and is current with the Series B Stock dividends.

Management has all options to redeem the Series B Stock, which carries a 9.0% dividend rate, under evaluation. The Company will take action to redeem the Series B Stock only when it is effective to do so and after a complete review of long term and short term considerations.

Beginning January 1, 2015, the Company and the Bank will be subject to the new capital requirements of Basel III. The Basel III Rules not only increase selected minimum regulatory capital ratios, but also introduce a new Common Equity Tier 1 capital ratio and the concept of a capital conservation buffer. The rules revise the criteria that certain instruments must meet to qualify as Tier 1 or Tier 2 capital. The Basel III Rules permit smaller banking organizations to retain, through a one-time election, the existing treatment of accumulated other comprehensive income. Management is reviewing the new rules to assess their impact on the Company.

48

Table of Contents

The Company's non-GAAP tangible common equity to tangible assets and the Tier 1 common equity to risk weighted assets increased to 7.15% and 6.50%, respectively, at September 30, 2014, compared to 3.67% and 0.77%, respectively, at December 31, 2013. The issuance of 15,525,000 common shares net of repurchasing 25,669 Series B Stock resulted in a positive impact on the regulatory ratios and the non-GAAP ratios noted above in the quarter ending September 30, 2014. The Company does not anticipate any significant effect to the Bank's regulatory ratios as the Company does not have any immediate plans to use any of the proceeds to increase Bank capital.

| (dollars in thousands) | (unaudited) As of September 30, | | (unaudited) As of December 31, |
|---|------------------------------------|------------|---|
| | 2014 | 2013 | 2013 |
| Tier 1 capital | | | |
| Total equity | \$ 192,691 | \$ 142,039 | \$ 147,692 |
| Tier 1 adjustments: | | | |
| Trust preferred securities allowed | 56,625 | 51,491 | 51,577 |
| Cumulative other comprehensive loss | 7,232 | 12,435 | 7,038 |
| Disallowed goodwill and intangible assets | - | (1,702) | (1,177) |
| Disallowed deferred tax assets | (65,260) | (71,588) | (70,350) |
| Other | (564) | (546) | (581) |
| Tier 1 capital | \$ 190,724 | \$ 132,129 | \$ 134,199 |
| Total capital | | | |
| Tier 1 capital | \$ 190,724 | \$ 132,129 | \$ 134,199 |
| Tier 2 additions: | | | |
| Allowable portion of allowance for loan losses | 16,782 | 16,565 | 15,898 |
| Additional trust preferred securities disallowed for tier 1 capital | - | 5,134 | 5,048 |
| Subordinated debt | 27,000 | 36,000 | 36,000 |
| Tier 2 additions subtotal | 43,782 | 57,699 | 56,946 |
| Allowable Tier 2 | 43,782 | 57,699 | 56,946 |
| Other Tier 2 capital components | (6) | (6) | (6) |
| Total capital | \$ 234,500 | \$ 189,822 | \$ 191,139 |
| Tangible common equity | | | |
| Total equity | \$ 192,691 | \$ 142,039 | \$ 147,692 |
| Less: Preferred equity | 47,331 | 72,667 | 72,942 |

Edgar Filing: OLD SECOND BANCORP INC - Form 10-Q

| | | | |
|-------------------------------------|--------------|--------------|--------------|
| Goodwill and intangible assets | - | 1,702 | 1,177 |
| Tangible common equity | \$ 145,360 | \$ 67,670 | \$ 73,573 |
| Tier 1 common equity | | | |
| Tangible common equity | \$ 145,360 | \$ 67,670 | \$ 73,573 |
| Tier 1 adjustments: | | | |
| Cumulative other comprehensive loss | 7,232 | 12,435 | 7,038 |
| Other | (65,824) | (72,134) | (70,931) |
| Tier 1 common equity | \$ 86,768 | \$ 7,971 | \$ 9,680 |
| Tangible assets | | | |
| Total assets | \$ 2,033,099 | \$ 2,032,788 | \$ 2,004,034 |
| Less: | | | |
| Goodwill and intangible assets | - | 1,702 | 1,177 |
| Tangible assets | \$ 2,033,099 | \$ 2,031,086 | \$ 2,002,857 |
| Total risk-weighted assets | | | |
| On balance sheet | \$ 1,300,773 | \$ 1,274,628 | \$ 1,224,438 |
| Off balance sheet | 34,883 | 37,555 | 36,023 |
| Total risk-weighted assets | \$ 1,335,656 | \$ 1,312,183 | \$ 1,260,461 |
| Average assets | | | |
| Total average assets for leverage | \$ 1,969,823 | \$ 1,857,554 | \$ 1,927,217 |

Table of Contents

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Liquidity and Market Risk

Liquidity is the Company's ability to fund operations, to meet depositor withdrawals, to provide for customers' credit needs, and to meet maturing obligations and existing commitments. The liquidity of the Company principally depends on cash flows from operating activities, investment in and maturity of assets, changes in balances of deposits and borrowings, and its ability to borrow funds. The Company monitors borrowing capacity at correspondent banks as well as the FHLBC and Reserve Bank as part of its liquidity management process as supervised by the Asset and Liability Committee and reviewed by the board of directors.

Net cash outflows from operating activities were \$14.4 million during the first nine months of 2014, compared with net cash inflows of \$19.7 million in the same period in 2013. Proceeds from sales of loans held-for-sale, net of funds used to originate loans held-for-sale, continued to be a source of inflows for both of the first nine months of 2014 and 2013. Interest paid, net of interest received, combined with changes in other assets and liabilities were a source of outflows for the first nine months of 2014 compared to inflows in the first nine months of 2013. The majority of this outflow was the payment of the accumulated and unpaid interest to the trust preferred securities totaling \$20.8 million. Management of investing and financing activities, as well as market conditions, determines the level and the stability of net interest cash flows. Management's policy is to mitigate the impact of changes in market interest rates to the extent possible, as part of the balance sheet management process.

Net cash outflows from investing activities were \$34.4 million in the first nine months of 2014, compared to net cash inflows of \$18.4 million in the same period in 2013. In the first nine months of 2014, securities transactions accounted for net inflows of \$7.2 million, and net principal disbursed on loans accounted for net outflows of \$53.0 million. In the first nine months of 2013, securities transactions accounted for net outflows of \$62.0 million, and net principal received on loans accounted for net inflows of \$49.9 million. Proceeds from sales of OREO accounted for \$12.7 million and \$32.1 million in investing cash inflows for the first nine months of 2014 and 2013, respectively.

Net cash inflows from financing activities in the first nine months of 2014 were \$45.2 million, compared with net cash outflows of \$86.5 million in the first nine months of 2013. Proceeds from the issuance of common stock provided net cash inflows of \$64.4 million, while the redemption of Series B Stock and dividends paid on Series B Stock accounted for net cash outflows of \$24.3 million and \$11.3 million, respectively, in the first nine months of 2014. Net deposit outflows in the first nine months of 2014 were \$25.4 million compared to net deposit outflows of \$44.1 million in the first nine months of 2013. Other short-term borrowings had net cash inflows of \$35.0 million and outflows of \$45.0 million related to FHLBC advance in the first nine months of 2014 and repayment in the first nine months of 2013. Changes in securities sold under repurchase agreements accounted for \$6.9 million and \$2.8 million in net inflows, respectively, in the first nine months of 2014 and 2013.

Interest Rate Risk

As part of its normal operations, the Company is subject to interest-rate risk on the assets it invests in (primarily loans and securities) and the liabilities it funds with (primarily customer deposits and borrowed funds), as well as its ability to manage such risk. Fluctuations in interest rates may result in changes in the fair market values of the Company's financial instruments, cash flows, and net interest income. Like most financial institutions, the Company has an exposure to changes in both short-term and long-term interest rates.

The Company manages various market risks in its normal course of operations, including credit, liquidity, and interest-rate risk. Other types of market risk, such as foreign currency exchange risk and commodity price risk, do not arise in the normal course of the Company's business activities and operations. In addition, since the Company does not hold a trading portfolio, it is not exposed to significant market risk from trading activities. The Company's interest rate risk exposures from September 30, 2014, and December 31, 2013, are outlined in the table below.

The Company's net income can be significantly influenced by a variety of external factors, including: overall economic conditions, policies and actions of regulatory authorities, the amounts of and rates at which assets and liabilities reprice, variances in prepayment of loans and securities other than those that are assumed, early withdrawal of deposits, exercise of call options on borrowings or securities, competition, a general rise or decline in interest rates, changes in the slope of the yield-curve, changes in historical relationships between indices (such as LIBOR and prime), and balance sheet growth or contraction. The Company's Asset and Liability Committee seeks to manage interest rate risk under a variety of rate environments by structuring the Company's balance sheet and off-balance sheet positions, which includes interest rate swap derivatives as discussed in Note 13 of the financial statements included in this quarterly report. The Company monitors and manages this risk within approved policy limits.

The Company utilizes simulation analysis to quantify the impact of various rate scenarios on net interest income. The simulation model incorporates specific cash flows, repricing characteristics, and embedded options of the assets and liabilities held by

Table of Contents

the Company. Earnings at risk is calculated by comparing the net interest income of a stable interest rate environment to the net interest income of different interest rate environments to determine the percentage change. Significant declines in interest rates that occurred during the first half of 2012 have made it impossible to calculate valid interest rate scenarios for rate declines of 1.0% or more. Compared to December 31, 2013 the Company had less earnings gains (in both dollars and percentage) if interest rates should rise. This decrease in rising-rate benefit reflects continued customer demand for longer term, fixed-rate loans. Federal Funds rates and the Bank's prime rate were stable throughout the first nine months of 2014, at 0.25% and 3.25%, respectively.

The following table summarizes the effect on annual income before income taxes based upon an immediate increase or decrease in interest rates of 0.5%, 1%, and 2% assuming no change in the slope of the yield curve. The -2% and -1% sections of the table do not show model changes for those magnitudes of decrease due to the low interest rate environment over the relevant time periods. While it was not possible to calculate net interest income for -0.5% as of December 31, 2013, increases in interest rates during the first nine months of 2014 made that calculation possible as of September 30, 2014, which is reflected in the table.

Analysis of Net Interest Income Sensitivity

| | Immediate Changes in Rates | | | | | | |
|--------------------|----------------------------|---------|----------|----------|----------|----------|--|
| | (2.0) % | (1.0) % | (0.5) % | 0.5 % | 1.0 % | 2.0 % | |
| September 30, 2014 | | | | | | | |
| Dollar change | N/A | N/A | \$ (275) | \$ (443) | \$ (198) | \$ 479 | |
| Percent change | N/A % | N/A % | (0.5) % | (0.8) % | (0.3) % | 0.8 % | |
| December 31, 2013 | | | | | | | |
| Dollar change | N/A | N/A | N/A | \$ 70 | \$ 249 | \$ 1,190 | |
| Percent change | N/A % | N/A % | N/A % | 0.1 % | 0.4 % | 2.1 % | |

The amounts and assumptions used in the simulation model should not be viewed as indicative of expected actual results. Actual results will differ from simulated results due to timing, magnitude and frequency of interest rate changes as well as changes in market conditions and management strategies. The above results do not take into account any management action to mitigate potential risk.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

The Chief Executive Officer and Chief Financial Officer have evaluated the effectiveness of the design and operation of the Company's disclosure controls and procedures, as defined in Rule 13a-15(e) promulgated under the Securities and Exchange Act of 1934, as amended, as of September 30, 2014. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that as of September 30, 2014, the Company's internal controls were effective to ensure that information required to be disclosed by the Company in reports that it files or submits under the Securities and Exchange Act of 1934 is recorded, processed, summarized, and reported within the time periods specified.

There were no changes in the Company's internal control over financial reporting during the quarter ended September 30, 2014, that have materially affected, or are reasonably likely to affect, the Company's internal control over financial reporting.

Forward-looking Statements

This document (including information incorporated by reference) contains, and future oral and written statements of the Company and its management may contain, forward-looking statements, within the meaning of such term in the Private Securities Litigation Reform Act of 1995, with respect to the financial condition, results of operations, plans, objectives, future performance and business of the Company. Forward-looking statements, which may be based upon beliefs, expectations and assumptions of the Company's management and on information currently available to management, are generally identifiable by the use of words such as "believe," "expect," "anticipate," "plan," "intend," "estimate," "may," "will," "would," "could," "should" or other similar expressions. Additionally, all statements in this document, including forward-looking statements, speak only as of the date they are made, and the Company undertakes no obligation to update any statement in light of new information or future events.

The Company's ability to predict results or the actual effect of future plans or strategies is inherently uncertain. The factors, which could have a material adverse effect on the operations and future prospects of the Company and its subsidiaries, are detailed in the "Risk Factors" section included under Item 1A. of Part I of the Company's Form 10-K. In addition to the risk factors described in that section, there are other factors that may impact any public company, including ours, which could have a material adverse effect on

Table of Contents

the operations and future prospects of the Company and its subsidiaries. These risks and uncertainties should be considered in evaluating forward-looking statements and undue reliance should not be placed on such statements.

52

Table of Contents

PART II - OTHER INFORMATION

Item 1. Legal Proceedings

The Company and its subsidiaries, from time to time, are involved in collection suits in the ordinary course of business against its debtors and are defendants in legal actions arising from normal business activities. Management, after consultation with legal counsel, believes that the ultimate liabilities, if any, resulting from these actions will not have a material adverse effect on the financial position of the Bank or on the consolidated financial position of the Company.

Item 1.A. Risk Factors

There have been no material changes from the risk factors set forth in Part I, Item 1.A. "Risk Factors," of the Company's Form 10-K for the year ended December 31, 2013. Please refer to that section of the Company's Form 10-K for disclosures regarding the risks and uncertainties related to the Company's business.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

None.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Mine Safety Disclosures

N/A

Item 5. Other Information

None

Item 6. Exhibits

Exhibits:

10.1 Employment Agreement, dated September 16, 2014, by and among Old Second Bancorp, Inc. and James Eccher (filed as Exhibit 10.1 to the Company's Form 8-K filed on September 18, 2014 and incorporated herein by reference).

31.1 Certification of Chief Executive Officer Pursuant to Rule 13a-14(a)/15d-14(a)

31.2 Certification of Chief Financial Officer Pursuant to Rule 13a-14(a)/15d-14(a)

32.1 Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

32.2 Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

101 Interactive data files pursuant to Rule 405 of Regulation S-T: (i) Consolidated Balance Sheets at September 30, 2014, and December 31, 2013; (ii) Consolidated Statements of Operations for the three and nine months ended September 30, 2014, and September 30, 2013; (iii) Consolidated Statements of Stockholders' Equity for the nine months ended September 30, 2014, and September 30, 2013; (iv) Consolidated Statements of Cash Flows for the nine months ended September 30, 2014, and September 30, 2013; and (v) Notes to Consolidated Financial Statements, tagged as blocks of text and in detail.*

* As provided in Rule 406T of Regulation S-T, these interactive data files shall not be deemed "filed" for purposes of Sections 11 and 12 of the Securities Act of 1933 and Section 18 of the Securities Exchange Act of 1934 as amended, or otherwise subject to liability under those sections.

Table of Contents

SIGNATURES

Pursuant to the requirements of the Securities and Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

OLD SECOND
BANCORP, INC.

~~BY~~ William B.
Skoglund
William B.
Skoglund

Chairman of the
Board, Director
President and
Chief Executive
Officer
(principal
executive officer)

~~BY~~ J. Douglas
Cheatham
J. Douglas
Cheatham

Executive
Vice-President and
Chief Financial
Officer, Director
(principal financial
and accounting
officer)

DATE: November 12, 2014

